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No. _____

In The

Supreme Court of the United States

RUTH E. JOHNSON, COMMISSIONER OF REVENUE, STATE OF TENNESSEE,

Petitioner,

v.

J.C. PENNEY NATIONAL BANK,

Respondent.

On Petition for Writ of Certiorari to the Court of Appeals of Tennessee

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED FOR REVIEW

May a State, in accordance with the nexus requirements of the Commerce Clause, impose franchise and income-based taxes on corporations that derive significant economic benefits from regular and continuous activities conducted in that State through means of interstate commerce, even though those corporations lack the physical presence in the State that this Court required in *National Bellas Hess, Inc. v. Department of Revenue* and *Quill Corporation v. North Dakota* for imposing a use-tax-collection duty?

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PETITION FOR WRIT OF CERTIORARI

Petitioner Ruth E. Johnson, Commissioner of Revenue, State of Tennessee, requests that a writ of certiorari issue to review the decision of the Court of Appeals of Tennessee entered in this case on December 17, 1999.

OPINIONS BELOW

The Opinion and Judgment of the Court of Appeals of Tennessee are unreported and are reproduced in the Appendix at 1a and 28a, respectively. The Order of the Supreme Court of Tennessee denying the Commissioner's Application for Permission to Appeal is unreported and is reproduced in the Appendix at 29a.

The Memorandum and Order of the Chancery Court of Davidson County, Tennessee, as well as that court's subsequent Final Order, are unreported and are reproduced in the Appendix at 30a and 48a, respectively.

JURISDICTION

The Court of Appeals of Tennessee, Middle Section, entered its Opinion and Judgment on December 17, 1999. The Commissioner filed a timely Application for Permission to Appeal to the Supreme Court of Tennessee, which was denied on May 8, 2000. This petition for writ of certiorari is filed within 90 days of that date in accordance with Sup. Ct. R. 13.1. This Court has jurisdiction to review on a writ of certiorari the decision in question pursuant to 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

This case involves the following constitutional and statutory provisions:

> U.S. CONST. art. I, §8, cl. 3 (the "Commerce Clause");
>
> U.S. CONST. art. VI, ¶2 (the "Supremacy Clause");
>
> U.S. CONST. amend XIV, §1 (the "Due Process Clause");
>
> 28 U.S.C. § 1257; and
>
> Tenn. Code Ann. §§ 67-4-801, 67-4-804, 67-4-805, 67-4-806, 67-4-815, 67-4-901, 67-4-903, 67-4-904, 67-4-906, 67-4-907, 67-4-919, 67-6-501, 67-6-502 and 67-6-503.

Unless otherwise noted, all citations in this Petition to Tennessee statutes refer to 1994 Replacement Volume 12 of the Tennessee Code Annotated, which contains the provisions in all relevant aspects as they were in effect for the audit period at issue. The text of these provisions is reproduced in the Appendix at 52a to 82a.

INTRODUCTION

In this case Tennessee has sought to impose its corporate franchise and excise taxes on a bank located outside of Tennessee that has focused its business and lending activities on the Tennessee marketplace through means of

interstate commerce and has thereby generated substantial income from Tennessee customers. Because J.C. Penney National Bank [hereinafter "JCPNB"] has purposefully availed itself of the economic opportunities offered by doing business with Tennessee customers, Tennessee has imposed on it a modest, properly-apportioned tax for the privilege of doing business in the State, based on its net worth and its net earnings from Tennessee. The question in this case is whether Tennessee may levy such a tax under the Commerce Clause of the United States Constitution, even though JCPNB has no offices, business locations, employees, or real or tangible property in Tennessee. This question requires a fundamental determination of whether the "substantial nexus" required by this Court's Commerce Clause precedents can be satisfied for purposes of corporate franchise and income-based taxes when the company has no physical presence in a State.

In *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992), this Court held that under the Commerce Clause a State may not impose a use-tax-collection duty on an out-of-state mail order seller unless that business has a physical presence in the State. The *Quill* decision made clear, however, that this "bright-line test" is limited in application to sales and use taxes. This case presents the important question of whether the *Quill* physical presence test should be extended to other types of State taxes or remain limited to the sales and use tax arena, in which settled expectations give the doctrine of *stare decisis* special weight. The issue of whether *Quill* should be extended beyond sales and use taxes has left the States in disarray, with State appellate courts in South Carolina, Ohio, and Illinois holding that *Quill* should not be

extended, while Michigan and Tennessee courts have now done just the opposite. This Court should grant plenary review to resolve this important Commerce Clause issue that has major repercussions on the States' essential power of taxation.

STATEMENT OF THE CASE

A. JCPNB's Business in Tennessee.

JCPNB is a federally-chartered national banking association incorporated under the laws of Delaware with its commercial domicile and principal place of business in Harrington, Delaware. Record [hereinafter "R."] at 17 (Stipulation of Facts, reproduced in the Appendix at 83a to 86a, at 83a), 58; Transcript of Trial Testimony [hereinafter "Tr."] at 28-30. It was acquired by the J.C. Penney Company [hereinafter "J.C. Penney"] in 1983 and functions as a wholly-owned subsidiary of its parent. (R. 1, 17, 58; Tr. 30-32). During the 1990 to 1994 period at issue in this case, JCPNB primarily engaged in consumer banking and credit card lending through the issuance of both Visa and MasterCard credit cards. (R. 1, 17, 58; Tr. 32-38). JCPNB issued these credit cards to customers throughout the United States, including Tennessee. (Tr. 191). In tax years 1990 to 1994, JCPNB had between 11,000 and 17,000 customers in Tennessee who held its Visa or MasterCard credit cards. It annually employed capital in Tennessee of more than $11,000,000, and it derived income from its credit card business in Tennessee of more than $2,000,000 annually. (Exhibits 15-18).

During the audit period in question, JCPNB had no offices, branches, or other places of business in Tennessee and did not own or lease any real or tangible personal property in Tennessee. It had no directors, employees, or agents in Tennessee. (R. 1, 17, 58; Tr. 28-30). It solicited customers for its credit card programs through direct mail to potential customers in Tennessee and other States. (Tr. 193-94, 199-205).

JCPNB outsourced most of the marketing and credit card servicing functions connected with its credit card lending activities to its parent, J.C. Penney, which is headquartered in Dallas, Texas, but which has numerous stores, offices, and employees in Tennessee. By contract, J.C. Penney was responsible for handling the soliciting of customers, issuing of credit cards, maintaining accounts, preparing statements, processing payments, and conducting merchant banking functions. (Tr. 62; Exhibit 8). J.C. Penney performed some of these duties itself, and others it subcontracted to several of its other subsidiaries. (Tr. 64, 67, 223-28, 322, 329-33; Exhibit 8). It contracted with Maryland Bank National Association ("MBNA"), an unrelated corporation, to handle the data processing associated with the credit card business. (Tr. 43-44, 181-82, 194, 320; Exhibit 9). There is no evidence in the record that any of J.C. Penney's subcontracted work was performed in Tennessee.

A major component of JCPNB's business plan was to solicit J.C. Penney customers who held that company's proprietary credit card that could be used only in J.C. Penney retail stores. J.C. Penney's Consumer Banking Division solicited credit card customers in Tennessee and other States on behalf of JCPNB, relying on the goodwill

and established relationships between J.C. Penney and its store credit card customers. During the audit period, 95% of the persons to whom JCPNB direct mail solicitations were sent were derived initially from J.C. Penney files. (Tr. 200-03; 240-43).

J.C. Penney marketed the JCPNB Visa and MasterCard credit cards by mailing pre-approved offers to Tennessee residents. (Tr. 190-93, 197, 199-206). A customer could accept the pre-approved offer by mailing the acceptance form to the J.C. Penney processing center in San Antonio, Texas. (Tr. 245-46). A JCPNB Visa or MasterCard credit card was then mailed by J.C. Penney's subcontractor to the customer. (Tr. 203-04). The JCPNB credit card agreement with its customers stated that the credit card remained the property of JCPNB. (Exhibits 49-50). J.C. Penney's Collection Division in Littleton, Colorado handled customer services for JCPNB cardholders through a toll-free 1-800 telephone number available to customers in Tennessee and other States. (Tr. 329). The Collection Division referred some cardholders to Consumer Credit Counseling Services, Inc. [hereinafter "CCCS"] in Tennessee, and JCPNB paid CCCS fees for successful collections. The Collection Division assigned accounts to collection agencies and attorneys for suit, and JCPNB used the Tennessee courts for collection suits. (Tr. 344-47).

JCPNB's business in Tennessee is dependent upon its participation in the Visa and MasterCard networks existing in the State. JCPNB is able to market and establish its customer base in Tennessee because member banks in these networks have marketed the credit card system to local merchants in Tennessee and contracted with those merchants to participate in the network and accept these

credit cards for purchases of goods and services. (Tr. 303-04, 391-95). The Visa and MasterCard networks constitute joint ventures among the member banks.[1]

JCPNB also operates as a merchant bank within the Visa and MasterCard networks. (R.18). It had merchant banking contracts with national merchants such as restaurants and service stations, with locations in Tennessee. J.C. Penney stores in Tennessee were also merchant banking customers of JCPNB for MasterCard transactions, and J.C. Penney served as JCPNB's agent to handle the merchant banking functions associated with MasterCard charges at J.C. Penney stores. (Tr. 142-43, Exhibit 38).

B. Tennessee's Franchise and Excise Taxes.

Tennessee imposes its franchise and excise taxes on the privilege of doing business in the State in corporate form. Tenn. Code Ann. § 67-4-806(a) (excise tax) (61a); § 67-4-903(a) (franchise tax) (69a).[2] The excise tax is measured by a corporation's net earnings based on federal

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[1] *See SFLC ILC, Inc. v. Visa U.S.A., Inc.*, 801 F.Supp. 517, 519 (D. Utah 1992); *SFLC ILC, Inc. v. Visa U.S.A., Inc.*, 36 F.3d 958, 960 (10th Cir. 1994); *National Bancard Corporation (NaBANCO) v. Visa U.S.A., Inc.*, 596 F.Supp. 1231, 1252 (S.D. Fla. 1984).

[2] These Code provisions were repealed in 1999 and replaced by new acts expanding and revising the franchise and excise taxes. *See* Tenn. Code Ann. § 67-4-2001 (Supp. 1999) *et seq.* (excise tax); § 67-4-2101 (Supp. 1999) (franchise tax). These recent acts do not alter the nature or incidence of these taxes in any way that would affect the issues in this case. All citations in the text of this Petition are to the provisions of the Tennessee Code as they stood during the tax period in question, February 1990 through January 1994.

taxable income, Tenn. Code Ann. § 67-4-805(a)(1), and the franchise tax is measured by a corporation's net worth, Tenn. Code Ann. §§ 67-4-904 and -906. (57a, 74a). Tennessee law contains special provisions imposing these taxes on financial institutions doing business in Tennessee. A financial institution is deemed to be doing business in Tennessee if it "regularly solicits business from potential customers" in Tennessee or "regularly engages in transactions with customers in [Tennessee] that involve intangible property, including loans, and result in receipts flowing to the taxpayer from within [Tennessee]." Tenn. Code Ann. §§ 67-4-806(d)(2); 67-4-903(f)(2). (62a-63a, 71a). A financial institution is presumed, "subject to rebuttal, to be doing business in this state if the sum of its assets and the absolute value of its deposits attributable to sources within [Tennessee] is five million dollars ($5,000,000) or more. Tenn. Code Ann. §§ 67-4-806(d)(1); 67-4-903(f)(1). (62a, 70a-71a).

Tennessee's franchise and excise taxes apportion the tax base on the basis of receipts derived from Tennessee. Tenn. Code Ann. § 67-4-815 (excise tax) (65a); § 67-4-919 (franchise tax) (77a). The excise tax equals six percent (6%) of the apportioned net earnings of the financial institution. Tenn. Code Ann. § 67-4-806(a). (61a). A financial institution apportions its net earnings by multiplying those earnings by a fraction, the numerator of which is the institution's receipts attributable to Tennessee and the denominator of which is the institution's total receipts attributable to transacting business everywhere. Tenn. Code Ann. § 67-4-815(a). (65a). A financial institution's franchise tax base is similarly apportioned according to the same fraction. Tenn. Code Ann. § 67-4-919(a). (77a).

For purposes of applying the apportionment formula, all interest income, merchant discounts, and other receipts and fees from a financial institution's credit card receivables are attributed to the State to which the card charges and fees are regularly billed. Tenn. Code Ann. §§ 67-4-815(d)(6) (excise tax) (67a-68a); 67-4-919(d)(6) (franchise tax) (80a).

The Tennessee Commissioner of Revenue audited JCPNB for the period from February 1990 through January 1994. On November 1, 1995, the Commissioner issued an assessment to JCPNB for this period in the amount of $178,314, including $111,725 in franchise and excise taxes, $27,932 in penalties, and $38,657 in interest.

C. The Proceedings Below.

JCPNB brought suit challenging the assessment in the Chancery Court of Davidson County, Tennessee, Part I. The complaint alleged that the assessment violated the Commerce Clause (R. 2, ¶9(a)) and Due Process Clause (R. 2-3, ¶¶9(b)&(c)) of the United States Constitution. The case was briefed on these issues and tried on February 9 and 10, 1998. On October 16, 1998, the Chancellor issued a Memorandum and Order (R. 57, 30a) finding that JCPNB does have sufficient nexus with Tennessee to satisfy both Commerce Clause and due process requirements. The Court determined that due process is satisfied because JCPNB has intentionally availed itself of Tennessee's marketplace and derives benefits from governmental services in Tennessee. (Memorandum at 10, R. 66, 44a). The Court further recognized that the requirement of physical presence for Commerce Clause nexus

pertains to use taxes under *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992), but it declined to accept such a requirement in this case because it found no implication in *Quill* that the physical presence requirement should be extended to other types of State taxes (Memorandum at 5, R. 61, 36a-37a). The Court held that since Tennessee's franchise and excise taxes as applied to JCPNB meet each of the four prongs of the test articulated in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977), the assessment must be upheld.

JCPNB did not appeal the trial court's due process holding, but it took that court's Commerce Clause holding to the Tennessee Court of Appeals. (Appellant's Brief in Court of Appeals at 1). That Court reasoned that while "JCPNB has reached out to the citizens of the State of Tennessee through the solicitations for credit cards" and "has purposefully availed itself of the substantial privilege of doing business in the State" (Opinion at 11, 15a-16a) so as to clearly satisfy due process nexus requirements, it felt constrained to impose a more stringent physical presence standard under the Commerce Clause. Declining to speculate on the development of this Court's jurisprudence, the Court of Appeals ruled that "[a]ny constitutional distinctions between the franchise and excise taxes presented here and the use taxes contemplated in *Bellas Hess* and *Quill* are not within the purview of this court to discern." (Opinion at 14; 20a). The Court also rejected the Commissioner's arguments that the presence of JCPNB's credit cards in Tennessee and its business relationship with other companies located in Tennessee amount to physical presence within the meaning of *Quill*. (Opinion at 15-19; 20a-26a).

REASONS FOR GRANTING THE WRIT

I. THE TENNESSEE COURT OF APPEALS HAS DECIDED AN IMPORTANT CONSTITUTIONAL QUESTION IN A WAY THAT CONFLICTS WITH RELEVANT DECISIONS OF THIS COURT.

A. The Decision Below Extends the "Physical Presence" Test for Commerce Clause Nexus Beyond the Sales and Use Tax Setting to Which This Court Carefully Limited It in *Quill*.

In *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992), this Court pronounced a bright-line, physical-presence requirement for the application of State sales and use taxes. The Court found that its jurisprudence had developed so that a taxpayer having substantial connections and deriving substantial benefits from a State without having a physical location there was subject to its taxing jurisdiction under the Due Process Clause, but it nevertheless held that nexus under the Commerce Clause requires a physical presence before a State may impose its sales and use taxes. The Court was very careful, however, to limit this physical presence requirement to State sales and use taxes. In its decision below, the Tennessee Court of Appeals has extended the physical presence requirement to Tennessee's franchise and excise taxes, which are based not on sales but on net worth and net earnings. In doing so, the Tennessee Court has ignored this Court's careful tailoring of the physical presence rule, and it has seriously narrowed State taxing jurisdiction. This Court should grant plenary review and reject such an unwarranted application of its precedents.

In *Quill*, North Dakota sought to impose a use-tax-collection duty on an out-of-state seller of office equipment and supplies. The State argued that a mail-order house engaged in continuous and widespread solicitation of business within the State through means of interstate commerce should be fully subject to that State's taxing jurisdiction. This Court held that North Dakota was justified in imposing the tax as a matter of due process, but it rejected the State's interpretation of the Commerce Clause, U.S. Const. art. I, §8, cl. 3. Instead, the Court adhered to its 25-year-old precedent in *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967), and held that vendors "whose only connection with customers in the [taxing] State is by common carrier or the United States mail" are "free from state-imposed duties to collect sales and use taxes." *Quill*, 504 U.S. at 315.

Nevertheless, throughout its opinion in *Quill* this Court limited its bright-line test to sales and use taxes. It observed that

> we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes . . . .

504 U.S. at 314. It noted that "a bright-line rule in the area of sales and use taxes also encourages settled expectations . . . . " 504 U.S. at 316. The Court concluded that,

> In sum, *although in our cases subsequent to Bellas Hess and concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement*, our reasoning in those cases does not compel that we now reject the rule that

> *Bellas Hess* established in the area of sales and use taxes.

504 U.S. at 317 (emphasis added). Indeed, in every instance in which the *Quill* Court refers to the physical presence test, it expressly restricts that test to sales and use taxes. This careful delimitation of the test perhaps derives from the Court's admission that "contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today . . . . " 504 U.S. at 311. The Court concedes that its maintenance of the physical presence rule is attributable more to principles of *stare decisis* than to current Commerce Clause doctrine. 504 U.S. at 317-18.[3]

Thus the *Quill* Court has sanctioned a bright-line, physical-presence test in measuring State sales and use taxes against the Commerce Clause, but it has left other State taxes to be adjudicated under the nexus requirements embodied in the first prong of the general standards for State taxation of interstate commerce, as announced in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). The Tennessee Court of Appeals, in applying the physical presence test to Tennessee's franchise and excise taxes, has greatly expanded the scope of that test

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[3] The decisive role of *stare decisis* in the *Quill* result is also revealed in the concurring opinion of Justices Scalia, Kennedy, and Thomas, who would have adhered to the *Bellas Hess* rule on grounds of *stare decisis* alone (Scalia, J., concurring in part and concurring in the judgment, 504 U.S. at 319, 320), and in the dissenting opinion of Justice White, who thought the physical presence rule so anachronistic that he would have abandoned it in spite of *stare decisis*. (White, J., concurring in part and dissenting in part, 504 U.S. at 321).

and thereby seriously undermined State taxing jurisdiction under the *Complete Auto* test. This Court should review this decision and determine if such an expansion of a rule that it so carefully circumscribed is warranted.

B. This Court Should Scrutinize the Extension of the Physical Presence Test to Other Types of State Taxation, Since Fundamental Commerce Clause Principles Counsel Against Such an Extension.

In *Quill*, this Court made clear for the first time that the nexus principles that animate the Due Process Clause differ from those that infuse meaning into the Commerce Clause. It observed that while "the Due Process nexus analysis requires that we ask whether an individual's connections with a State are substantial enough to legitimate the State's exercise of power over him," the Commerce Clause and its nexus requirement are informed "by structural concerns about the effects of state regulation on the national economy." 504 U.S. at 312. Thus the crucial nexus standards that should be applied in this case are designed to limit improper State burdens on interstate commerce. The Tennessee Court, in blindly applying a physical presence test outside its proper context, missed these considerations entirely. Before such a restrictive test is imposed on State franchise and income-based taxes, this Court should take an opportunity to consider if structural concerns about State regulation of the national economy are different for sales and use taxes than for other taxes.

Some significant differences are immediately apparent and deserve this Court's consideration. A driving force in the sales and use tax area was the Court's concern that more than 6,000 local taxing jurisdictions in the United States might impose various rates, exemptions, and reporting requirements for such taxes. *Quill*, 504 U.S. at 313 n.6. Since sales and use tax returns are generally due each month, firms with nationwide business would face the possibility of having annually to compute 72,000 different tax liabilities and file tens of thousands of returns. These concerns are greatly reduced in the realm of corporate franchise and income taxes. Such taxes are imposed by only 48 jurisdictions [46 States, the District of Columbia, and New York City], each of which requires an annual return. CCH Multistate Corporate Income Tax Guide ¶196. The measure of the Tennessee excise tax is federal taxable income, which happens to be a computation that the taxpayer has already prepared for federal purposes. Approximately 44 States use this same measure. *Id.*, ¶125. The franchise tax is computed on balance sheet information that a business would compile annually for financial reporting purposes. Even though there are adjustments to net income and other variations from State to State, the compliance burden with respect to franchise and excise taxes is in no sense equivalent to the use-tax-collection duty compliance requirements. As one noted commentator puts it,

> it may well be that the need for a "bright-line" rule in the context of income taxation is less compelling than in the context of sales and use taxation because the burdens of complying with the income tax laws of various state and local jurisdictions are less daunting than the burden

> of complying with the laws of the nations' 6,000-plus sales and use tax jurisdictions to which the Court alluded in *Quill*.

J. HELLERSTEIN & W. HELLERSTEIN, STATE TAXATION (Warren, Gorham & Lamont 3d ed. 1998) [hereinafter "HELLERSTEIN"] ¶6.30[5]. Certainly the relative compliance burdens constitute one factor that this Court should consider before a physical presence requirement is extended to franchise and income-based taxes.

Besides the burdens of compliance, this Court should consider several other factors that arguably differentiate sales and use taxes from other State taxes insofar as structural concerns about taxation of the national economy are reflected in the Commerce Clause test for nexus. The *Quill* Court stressed that the physical presence test for sales and use taxes "encourages settled expectations and, in doing so, fosters investment by businesses and individuals." 504 U.S. at 316, 112 S.Ct. at 1915. It thus reaffirmed the *Bellas Hess* rule, around which a substantial industry had developed. No such "settled expectations" exist, however, concerning other types of State taxes, because no decision of this Court has pronounced a physical presence test for other taxes. The Court noted in *Quill* that in *Arkansas Electric Cooperative Corp. v. Arkansas Public Service Commission*, 461 U.S. 375 (1983), it had overturned even a previous bright-line test where reliance interests were weak. 504 U.S. at 316. Because the *Quill* test is based principally on *stare decisis* concerns, it should not automatically be carried over to other taxing schemes where no such reliance interests exist.

In addition, a crucial distinction is that sales taxes are unique because they are designed to be passed on by the

authority of the State to the final consumer of the goods or services sold as a separately-stated additional charge over and above the negotiated contract price, not borne by the seller out of its earnings.[4] This means that a business against which a sales tax or a use-tax-collection duty is belatedly assessed must pay out of its own pocket taxes that should have been borne economically by its myriad customers. This feature makes sales and use taxes particularly burdensome to businesses that are unexpectedly assessed and no longer have any practical means of passing the tax liability on to their customers. Thus concerns about retroactivity, such as those expressed in *Quill*, 504 U.S. at 318 n.10 (majority opinion); 504 U.S. at 332-33 (White, J., dissenting), are at their highest in the sales and use tax arena. Such concerns are greatly lessened as to franchise and excise taxes, which are designed to be paid out of a corporation's earnings or receipts. Concerning franchise and excise taxes, retroactive application is merely a matter of timing the payment of a corporate liability; concerning sales taxes and the use-tax-collection duty, it is a matter of assuming in its entirety a tax burden designed to be borne by others.

These and other significant distinctions of sales and use taxes counsel that a test crafted from that realm ought not to be lightly imposed elsewhere. This Court ought at least to consider these structural factors pertaining to the

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[4] *See* Tenn. Code Ann. §§ 67-6-502 and 67-6-503, requiring the sales tax burden to be passed on to the customer to the extent possible, even though the incidence of the tax falls technically on the seller. Tenn. Code Ann. § 67-6-501; *Beare Co. v. Olsen*, 711 S.W.2d 603 (Tenn. 1986); *Sam Carey Lumber Co. v. Sixty-One Cabinet Shop, Inc.*, 773 S.W.2d 252 (Tenn. App. 1989).

States' power to tax the national economy before it allows a physical presence test to be imposed on other State taxing mechanisms.

C. This Court Should Carefully Review Any Proposed Extension of the Physical Presence Test to Franchise and Income-Based Taxes, Since That Test Conflicts with Previous Decisions of This Court and Would Severely Undermine State Taxing Authority.

The function of the Commerce Clause nexus doctrine is to protect both the free flow of commerce between States and the fundamental power of the States to levy essential taxes, many of which are used to maintain the infrastructure that supports interstate commerce. The Court ought to review the judgment below because it upsets the balance between these interests so carefully weighed in its previous decisions.

This Court has long held that State income taxes may be levied against nonresidents. In *Shaffer v. Carter*, 252 U.S. 37, 52 (1920), the Court upheld the imposition of an Oklahoma income tax on an Illinois resident under both the Due Process Clause and Commerce Clause, and observed that

> just as a state may impose general income taxes upon its own citizens and residents whose persons are subject to its control, it may, as a necessary consequence, levy a duty of like character, and not more onerous in its effect, upon incomes accruing to nonresidents from their property or business within the state, or their occupations carried on therein . . . .

The Court cited this decision in upholding Tennessee's excise tax in *Memphis Natural Gas Co. v. Beeler*, 315 U.S. 649, 656 (1942), stating that an excise tax could be imposed with respect to "net income derived from within the state" without violating the Commerce Clause. Similarly, in upholding a Wisconsin tax on corporate dividends distributed to stockholders, this Court in *International Harvester Co. v. Wisconsin Department of Taxation*, 322 U.S. 435 (1944), reasoned,

> Personal presence within the state of the stockholder-taxpayers is not essential to the constitutional levy of a tax taken out of so much of the corporation's Wisconsin earnings as is distributed to them. *A state may tax such part of the income of a non-resident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are subject to state regulation and which are within the protection of the state and entitled to the numerous other benefits which it confers.*

322 U.S. at 441-42 (emphasis added).

While there may have been some form of physical presence in these instances, the Court's reasoning and the rules it announced in these cases did not make physical presence a prerequisite for the levy of State income taxes.[5] Nevertheless, the decision of the Tennessee Court

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[5] Subsequent State decisions have upheld income-based and other State taxes even though the taxpayer did not have a physical presence in the taxing State. *See In re Heftel Broadcasting Honolulu, Inc.*, 57 Haw. 175, 554 P.2d 242 (1976), *cert. denied*, 429 U.S. 1073 (1977); *American Dairy Queen Corp. v. Taxation and Revenue Dept.*, 93 N.M. 743, 605 P.2d 251 (Ct. App. 1979);

of Appeals has done so, contrary to the implications of these precedents, as well as the careful delimitations in *Quill*. This Court ought not allow such an important principal of constitutional law to be so unwittingly extended.

This is particularly true because the States' power to tax is necessary to their sovereignty and essential to their ability to provide the services that today's citizenry and economy demand. With modern innovations in transportation and communications, a physical location within a State is of ever *decreasing* importance in enabling businesses to operate there. Moreover, modern computer technology has tremendously reduced the burden of complying with the tax reporting requirements of multiple jurisdictions. A physical presence test ties the States' taxing authority to a standard that may once have been a realistic reflection of economic necessities but which grows more anachronistic with each passing day. While the peculiar circumstances discussed in Part I(B) *supra* offer some justification for such a test in the limited arena of sales and use taxes, the Tennessee Commissioner submits that no realistic basis for such a rule exists in the realm of franchise and income-based taxes. At the least this Court should consider the issue thoroughly before allowing its carefully tailored physical presence rule to be extended to the entire range of State taxes.

AAMCO Transmissions, Inc. v. Taxation and Revenue Dept., 93 N.M. 389, 600 P.2d 841 (Ct. App.), *cert. denied*, 93 N.M. 205, 598 P.2d 1165 (1979); *Baskin-Robbins Ice Cream Co. v. Revenue Div.*, 93 N.M. 301, 599 P.2d 1098 (Ct. App. 1979); *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 313 S.C. 15, 437 S.W.2d 13, *cert. denied*, 510 U.S. 992 (1993).

II. THE STATE COURTS ARE IN CONFLICT OVER THE PROPER CONSTITUTIONAL TEST FOR COMMERCE CLAUSE NEXUS FOR GENERAL TAX LEVIES.

In attempting to apply this Court's Commerce Clause doctrines, the State courts since *Quill* have fallen into disarray over the standard for determining State taxing nexus. Despite the clear statement in *Quill* that this Court has not adopted a bright-line physical presence requirement for other types of taxes, some courts, just as the Tennessee court below, have extended the requirement beyond sales and use taxes. Others, taking this Court in *Quill* at its word, have flatly ruled that physical presence is unnecessary for nexus to levy other types of taxes. This Court should clarify the limits of the physical presence test in order to prevent both improper State burdens on interstate commerce and improper restraints on essential State taxing power.

Contrary to the decision below, several State appellate courts have taken literally this Court's pronouncements in *Quill* and have limited the physical presence test for nexus under the Commerce Clause to State sales and use taxes. In the leading post-*Quill* case, *Geoffrey, Inc. v. South Carolina Tax Commission*, 313 S.C. 15, 437 S.E.2d 13, *cert. denied*, 510 U.S. 992 (1993), the South Carolina Supreme Court upheld the application of that State's income tax and business license fees to royalty income of a corporation having no physical presence in South Carolina. The court stated that "[i]t is well settled that the taxpayer need not have a tangible, physical presence in a state for income to be taxable there. The presence of intangible property alone is sufficient to establish nexus."

313 S.C. at 23, 437 S.E.2d at 18. The Court reasoned that because the taxpayer was licensing intangibles for use in the State and deriving income from that use, it had created a "substantial nexus" with South Carolina within the meaning of the first prong of the *Complete Auto* nexus test. 313 S.C. at 23-24, 437 S.E.2d at 18. This Court declined to review that decision.

Similarly, the Supreme Court of Ohio in *Couchot v. State Lottery Commission*, 74 Ohio St.3d 417, 659 N.E.2d 1225, *cert. denied*, 519 U.S. 810 (1996), applied that State's income tax to a nonresident winner of the State lottery. The Court observed, "There is no indication in *Quill* that the Supreme Court will extend the physical-presence requirement to cases involving taxation measured by income derived from the state. . . . Thus, the physical-presence requirement of *Quill* is not applicable to the case sub judice." 74 Ohio St.3d at 425, 659 N.E.2d at 1230. Also, in *Borden Chemicals & Plastics, L.P. v. Zehnder*, 312 Ill.App.3d 35, 726 N.E.2d 73 (2000), the Illinois Appellate Court upheld the application of that State's "personal property tax replacement *income* tax" to an out-of-state limited partner in a partnership operating in Illinois. The Court rejected out of hand the suggestion that *Quill* had "left open" the question of whether a physical presence is required concerning other types of taxes. Instead, it ruled that "the physical presence requirement of *Quill* is inapplicable to the instant case." 312 Ill.App.3d at 44, 726 N.E.2d at 80.

The decision of the Tennessee court below is obviously in direct conflict with these rulings from other States. But the Michigan decision in *Guardian Industries Corp. v. Department of Treasury*, 198 Mich. App. 363, 499

N.W.2d 349 (1993), agrees with the Tennessee court's expansive reading of *Quill*'s physical presence test. There, in applying Michigan's single business tax, the court had to determine if the taxpayer was subject in other States to a business privilege tax, income tax, franchise tax measured by income, franchise tax for the privilege of doing business, corporate stock tax, or another consumption type value-added tax. 198 Mich.App. at 370, 499 N.W.2d at 353. The court ruled that "after *Quill*, it is abundantly clear that Guardian must show a physical presence within a target state to establish a substantial nexus to tax it" under any of these taxing schemes. 198 Mich.App. at 377, 499 N.W.2d at 356.[6]

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[6] In *Cerro Copper Products, Inc. v. Alabama Dept. of Revenue*, No. F.94-444 (Ala. Adm. Judge, Dec. 11, 1995), State Tax Notes, Jan. 1, 1996, at 65, 66, an Alabama administrative law judge applied the physical presence test to that State's franchise tax, stating,

> If the Taxpayer does not have sufficient nexus with Alabama for sales and use tax purposes, which it clearly does not have under *Quill*, then it is incongruous that the Taxpayer would have "substantial nexus" to be subject to Alabama's franchise tax. As a practical matter, the same benefits of a bright-line, physical presence test cited in *Quill* . . . for sales and use tax purposes would also apply equally to other types of taxes.

Also, in *MCI International Telecommunications Corp. v. Comptroller of the Treasury*, 1999 WESTLAW 322702 (Md. Tax. Ct. 1999), *aff'd*, 2000 STT ["State Tax Today"] 60-22 (Md. Cir. Ct. for Baltimore City, Mar. 17, 2000), the Maryland courts in an income tax case "hesitate[d] to expand the *Quill* physical presence requirement to taxes other than sales and use," but they nevertheless appear to have applied a similar nexus analysis and struck down the tax.

Thus despite the clear language of *Quill*, great confusion reigns over the scope of the physical presence test, among the courts, scholars, and commentators. As a leading tax treatise observes,

> *Quill* therefore plausibly may be read to have established a "bright-line" physical-presence standard only for sales and use taxes on the mail-order industry, relegating other industries and other taxes to "the more flexible balancing analyses" the Court's "Commerce Clause jurisprudence now favors."
>
> * * *
>
> This is not to suggest that such a reading is the *only* plausible reading *Quill* may be given. Indeed, as an original matter, one would be hard put to justify a constitutional rule that applied only to one industry.

HELLERSTEIN ¶6.02[2]. The Commissioner submits that the decision below is in conflict with both the *Quill* opinion itself and the better-reasoned subsequent State court decisions. Because of the conflict among the lower courts on this important question of Commerce Clause jurisprudence and State sovereignty, the Court should grant plenary review of the decision below.

III. THIS COURT OUGHT TO CLARIFY ITS COMMERCE CLAUSE JURISPRUDENCE SINCE *QUILL* HAS PRODUCED A SITUATION IN WHICH THERE IS A BRIGHT-LINE TEST FOR SALES-AND-USE-TAX NEXUS BUT VIRTUALLY NO GUIDANCE CONCERNING COMMERCE CLAUSE NEXUS FOR OTHER TAXES.

The *Quill* opinion has left the courts, taxing authorities, and businesses adrift as to nexus requirements for State taxes other than sales and use taxes. It is ironic that the *Quill* ruling is largely premised on the desirability of a bright-line rule in tax matters, and yet has engendered only confusion about the proper test to apply for taxing nexus under the Commerce Clause generally. While *Quill* explains that nexus considerations under the Commerce Clause, in contrast to the Due Process Clause, focus on "limiting state burdens on interstate commerce," it offers no clear guidance about the factors that determine whether such improper burdens exist. *Quill*, 504 U.S. at 313. If a bright-line test is so beneficial as to sales and use taxes, surely the Court should establish some meaningful guideposts for nexus determinations about other State taxes. Under the first prong of the *Complete Auto* test, this Court is free to fashion nexus principles for general taxation that accurately reflect the manner in which business is done in today's economy. Those principles should permit a State to tax businesses which purposefully exploit the market within that State and which derive substantial business and income from regular and continuous activities that they direct toward customers in that State, even if those activities are conducted through means of interstate commerce rather than through a local office or salesforce.

The Court below, finding no guidance as to Tennessee's franchise and excise taxes, reverted to the physical presence test in spite of *Quill*'s careful restriction of that test to sales and use taxes. In doing so, it has come into conflict not only with *Quill*, but with other State court decisions that have followed the *Quill* analysis. *Quill* itself recognized the problem: "[T]he 'application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensable power of taxation.' " *Quill*, 504 U.S. at 315-16, quoting *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 457-458 (1959). This case offers an appropriate opportunity for the Court to extricate this area of constitutional jurisprudence from a legal quagmire that itself impedes the nation's economy by forcing States and businesses to use their resources in litigation rather than more productive pursuits.

As Professor Hellerstein has observed, "[i]n light of the Court's lukewarm endorsement of the physical-presence standard of nexus, the implications of *Quill* for jurisdiction to impose corporate income, franchise, capital stock, and other taxes are neither as clear nor as sanguine as they are for mail-order vendors." HELLERSTEIN ¶6.02[2]. He further notes that "[i]t is by no means apparent that these pragmatic considerations [influencing the *Quill* decision] would justify a bright-line physical-presence standard with respect to other taxes." *Id.* In decisions applying the *Complete Auto* test prior to *Quill*, the nexus requirement was satisfied by a finding that a taxpayer exercised the substantial privilege of doing business in the taxing State. *See Exxon Corporation v. Wisconsin*

Department of Revenue, 447 U.S. 207, 219-20 (1980). This standard is more than a mere "minimum contacts" standard necessary to support *in personam* jurisdiction. If this approach is deemed to have been discarded by *Quill*, as the court below concluded, then the State courts are left with no guidance to determine the requirements for "substantial nexus" under *Complete Auto*.[7]

Obviously Congress, within the bounds of due process, can address these Commerce Clause concerns. Congress is aided, however, when this Court presents to it a coherent body of constitutional law upon which to operate. In contrast to the situation in *Quill*, in this case there are no settled expectations that enhance the role of *stare decisis* or justify a departure from the Court's general Commerce Clause jurisprudence. In the absence of congressional action, the States and taxpayers deserve to know the general nexus principles for State taxation. Those principles should recognize the ability of a State to impose its general privilege and income taxes on businesses that purposely avail themselves of the market

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[7] The *Complete Auto* test relied on principles developed in this Court's earlier decisions, as noted in footnote 8 of the *Complete Auto* opinion. 430 U.S. at 279. Those decisions did not use the term "substantial nexus," but used the term "nexus" to refer to jurisdiction to tax under the Commerce Clause and to a related due process analysis based on the taxpayer's exercising the substantial privilege of doing business in the taxing State and enjoying the benefits, protections, and opportunities afforded by the State. *See, e.g., General Motors Corp. v. Washington*, 377 U.S. 436 (1964); *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959); *Memphis Natural Gas Co. v. Stone*, 335 U.S. 80 (1948); *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940).

within that State, derive substantial income from doing business within that State, and enjoy the services and protections afforded by that State, whether they do so through a physical presence in the State or by means of interstate commerce. If a company has established continuing business relationships with customers in a State through interstate commerce, it should be subject to the same general taxes on the privilege of doing business in that State as are its competitors that have local offices or employees.

The Court below deemed itself unable to supply the constitutional nexus standards for Tennessee's franchise and excise taxes, and thus extended *Quill*'s physical presence test in an unwarranted manner. In doing so, it brought itself into direct conflict with other courts that have taken a broader view of State taxing jurisdiction in the wake of *Quill*. This Court should grant review in this case to resolve these conflicts and extricate Commerce Clause jurisprudence from a continuing quagmire with respect to the States' fundamental power of taxation.

CONCLUSION

For these reasons, the Commissioner requests that a Writ of Certiorari issue to review the judgment of the Tennessee Court of Appeals.

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IN THE COURT OF APPEALS OF TENNESSEE
AT NASHVILLE

J.C. PENNEY NATIONAL BANK,	Davidson Chancery No. 96-276-I
Plaintiff/Appellant,	Appeal No. M1998-00497-COA-R3-CV
VS.	
RUTH E. JOHNSON, Commissioner of Revenue, State of Tennessee,	
Defendant/Appellee.	

APPEAL FROM THE CHANCERY COURT
OF DAVIDSON COUNTY
AT NASHVILLE, TENNESSEE
THE HONORABLE ERNEST PELLEGRIN,
SPECIAL CHANCELLOR

(Filed December 17, 1999)

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REVERSED AND DISMISSED

ALAN E. HIGHERS, J.

CONCUR:

DAVID R. FARMER, J.

HOLLY KIRBY LILLARD, J.

The J.C. Penney National Bank appeals from the Chancery Court of Davidson County, which upheld the imposition of franchise and excise taxes against the Bank

by the Tennessee Department of Revenue. For the reasons stated herein, we reverse the decision of the trial court.

Facts and Procedural History

At all relevant times, the J.C. Penney National Bank[1] ("the National Bank" or "JCPNB") was a federally chartered national banking association incorporated under the laws of Delaware with its principal place of business and commercial domicile in Harrington, Delaware. Ruth E. Johnson ("Commissioner") was the Commissioner of Revenue for the State of Tennessee and was named in this case in her official capacity. The present appeal arises from the Commissioner's imposition of franchise and excise taxes against JCPNB on income allegedly generated by JCPNB's credit card activities in the State of Tennessee. In order to clarify the positions of the respective parties, we find it necessary briefly to describe, perhaps to the point of oversimplification, the various entities and procedures involved in JCPNB's credit card business.

Through its Delaware offices, JCPNB offers consumer banking services such as deposit accounts, home mortgage lending, general consumer loans, and automated teller machine ("ATM") services. In addition to the normal banking services which it provides, JCPNB engages in credit card lending through the issuance of Visa and

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[1] The National Bank was acquired by the J.C. Penney Company, Inc. in 1983.

MasterCard credit cards.[2] JCPNB has been issuing Visa credit cards since 1983, and MasterCard credit cards since 1984.

JCPNB contracted with the J.C. Penney Company, its parent company, to perform various marketing and processing services that were necessary to create and maintain JCPNB's credit card business. Under that contract, the J.C. Penney Company agreed to provide services such as credit card solicitation, marketing, statement and payment processing, customer service, and collection. The J.C. Penney Company, in turn, contracted with other companies to provide many of these services.

The J.C. Penney Company contracted with Maryland Bank National Association ("MBNA"), an unrelated corporation domiciled in Texas, to provide the data processing related to the National Bank's credit card business. MBNA is a company that offers credit card processing services to a variety of banks. As transactions were received through the Visa or MasterCard network, MBNA posted them to the appropriate cardholder account. MBNA was also responsible for sending out account statements each month.

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[2] We stress, as does the appellant, that JCPNB's Visa and MasterCard credit card business exists independent of the J.C. Penney Company's "proprietary card business." Visa and MasterCard are membership corporations consisting of member banks throughout the United States and the world, formed to facilitate the use of credit cards. While the Visa and MasterCard cards issued by JCPNB may be used at many locations, the proprietary card issued by J.C. Penney may only be used at J.C. Penney retail stores.

The J.C. Penney Company also contracted with Business Services, Inc. ("BSI"), a wholly owned subsidiary, to provide general marketing and payment processing services.[3] After MBNA sent monthly statements to the cardholders, the cardholders would send their payments to a BSI payment processing center in San Antonio, Texas. Also, as part of its marketing responsibilities, BSI solicited credit card accounts on behalf of JCPNB. These solicitations were sent via U.S. Mail to potential customers throughout the United States, including Tennessee.[4] As the first step in the solicitation process, BSI obtained the names of possible customers. Some names were obtained from a list of people who had a prior credit history with the J.C. Penney Company. BSI also obtained potential customer names through the use of mailing lists from various credit bureaus.[5] BSI would then submit the list of

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[3] In 1996, BSI was sold to an unrelated third party and became Alliance Data Systems, Inc. After the sale, Alliance continued to provide the same services for JCPNB at the same prices and on the same terms.

[4] There was, however, no solicitation which specifically targeted Tennessee residents.

[5] Local credit bureaus in Tennessee are operated as for-profit corporations or as non-profit corporations formed by local merchants for the purpose of assembling necessary credit information for the merchants to engage in credit transactions. Local merchants who are members of a credit bureau provide their credit files to the local credit bureau of which they are a member. The local bureau is usually an affiliate of one of the three national automated consumer reporting agencies (Transunion, TRW, or Equifax). The local credit bureau forwards the local creditors' account information to its national consumer reporting affiliate. The national agency incorporates this credit information into its existing credit files. When JCPNB

potential cardholders to a national credit bureau who would select those people having a credit profile consistent with the criteria established by JCPNB. The selected people would then receive an offer to apply for a credit account with the National Bank.

None of the activities described above occurred in the State of Tennessee, other than the solicitations being mailed to Tennessee residents. Also, all of the entities involved in the National Bank's credit card operation were located outside the State of Tennessee.[6] JCPNB itself maintained no offices or places of business in Tennessee, nor did it have any employees in the State.

The Visa and MasterCard credit cards issued by the National Bank were "universal cards." This name derives from the fact that these cards could be used to purchase goods and services throughout the world from any retailer who displayed the Visa or MasterCard logo.[7] A credit card purchase may be made in two ways. The most common transaction occurs when the cardholder presents the card to a merchant and the merchant swipes the card through a point of sale terminal. The terminal reads the magnetic strip on the back of the card and transmits a

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contracted with national credit reporting agencies, it did so through contracts negotiated with the agencies' national offices, which were outside of Tennessee.

[6] The J.C. Penney Company does own and operate the J.C. Penney retail stores that are located in Tennessee. However, as will be dealt with in more detail later, those stores were not involved in the National Bank's credit card business.

[7] The cards may also be used to secure cash advances at participating Automated Teller Machines ("ATM's").

request for authorization to the issuing bank. Another type of transaction can occur when the cardholder provides a merchant with his or her account number and expiration date, but does not physically present the card to the merchant. This type of transaction generally occurs when purchases are being made over the telephone or, in today's world, via the internet. In either case, a sales slip is generated which the merchant submits to a merchant bank with whom the merchant has a contract.[8] The merchant bank will then remit the transaction amount to the merchant minus a discount. The merchant bank may be located inside or outside Tennessee.

The merchant bank records the information from the sales slip and transmits the information to a VISA (USA) Inc. or MasterCard international, Inc. interchange center for the purpose of obtaining payment of the face amount of the slip, less an interchange fee, from the bank that issued the credit card, which, in this case, was JCPNB.

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[8] Merchant banks can be divided into two groups. One group is comprised of those banks which have entered into national contracts which cover all locations of a merchant throughout the United States. The other group of merchant banks is comprised of banks which have entered into contracts with individual Tennessee merchants to accept charge slips from Visa and MasterCard credit card transactions. JCPNB serves as a merchant bank for some merchants with store locations throughout the United States, including Tennessee. Under these agreements, each merchant has agreed to accept the Visa or MasterCard credit cards for purchases and JCPNB has agreed to accept the charge slips from these transactions for payment to the merchant's account. These agreements were negotiated between JCPNB and the merchant's corporate headquarters, rather than with a local outlet of a merchant. No such merchant had their corporate headquarters in Tennessee.

Visa and MasterCard regularly inform JCPNB of the amount owed by it with respect to sales slips which have been submitted by all merchant banks. From Delaware, the National Bank transfers funds to pay these amounts.

The J.C. Penney National Bank charged an annual fee on most Visa and MasterCard credit card accounts, as well as interest and other fees in connection with the account. The National Bank then paid an income tax to the State of Delaware based upon 100% of the National Bank's net income. JCPNB had never filed a franchise or excise tax return with the Tennessee Department of Revenue, nor had it ever paid any franchise or excise taxes to the State of Tennessee. However, the Field Audit Division of the Tennessee Department of Revenue audited JCPNB in 1995 for the period of February 1990 through January 1994. On November 1, 1995, the Department of Revenue issued an assessment to the National Bank in the amount of $178,314, which included $111,725 in franchise and excise taxes, $27,932, in penalties, and $38,657 in interest. The assessment was based on the determination that JCPNB was a "financial institution" as defined in T.C.A. § 67-4-804(a)(8) and was subject to franchise and excise taxation under T.C.A. §§ 67-4-806 and 67-4-903. In calculating the taxes, the Department of Revenue applied the single-factor, gross receipts apportionment formula applicable to financial institutions found in T.C.A. §§ 67-4-815 and 67-4-919.

In accordance with T.C.A. § 67-1-1801, the National Bank filed this action contesting the assessment of the franchise and excise taxes on three grounds: (1) the assessment violated the Commerce Clause of the United States Constitution; (2) the assessment violated the Due

Process Clause of the United States Constitution; and (3) basing the assessment upon the single receipts factor apportionment formula violated the Due Process Clause of the United States Constitution. The case was tried in the Chancery Court of Davidson County on February 9 and 10, 1998. The chancellor issued a memorandum opinion on October 16, 1998 upholding the assessment. The chancellor concluded that the assessment was not violative of the requirements of the Due Process Clause of the United States Constitution, and a sufficient nexus existed between the State of Tennessee and JCPNB to satisfy the requirements of the Commerce Clause. The Commissioner filed a motion to alter or amend the order because it did not provide for a judgment against JCPNB for the disputed tax liability and did not provide for an award of attorney's fees and expenses pursuant to T.C.A. § 67-1-1803(d). The chancellor entered a final order on December 7, 1998, awarding judgment in favor of the Commissioner in the amount of $178,314, as well as awarding attorney's fees and expenses to the Commissioner as the prevailing party. This appeal followed.

On appeal, JCPNB presents a single question for review. That question is whether JCPNB's relationship with the State of Tennessee satisfies the "substantial nexus" requirement of the Commerce Clause.

Law and Analysis

Financial institutions "doing business" in the State of Tennessee are subject to excise and franchise taxes

pursuant to T.C.A. §§ 67-4-806(d)(2)[9] and 67-4-903(f)(2)[10]. The Commissioner contends that JCPNB's credit card activities come within the terms of the statutory provisions because JCPNB: (1) regularly solicits business from customers in Tennessee; (2) provides credit card services to its customers; (3) engages in transactions in which it extends credit to these customers; and (4) receives interest income and fee income from these transactions and loans. Appellee's Brief at p. 10. JCPNB, however, does not challenge the statutes pursuant to which the taxes were imposed. Rather, JCPNB contends that its contacts with

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[9] (2) Additionally, a financial institution shall be deemed to be doing business in this state if the institution:

(A) Maintains an office in this state;

(B) Has an employee, representative or independent contractor conducting business in this state;

(C) Regularly sells products or services of any kind or nature to customers in this state that receive the product or service in this state;

(D) Regularly solicits business from potential customers in this state;

(E) Regularly performs services outside this state which are consumed in this state;

(F) Regularly engages in transactions with customers in this state that involve intangible property, including loans, and result in receipts flowing to the taxpayers from within this state;

(G) Owns or leases property located in this state; or

(H) Regularly solicits and receives deposits from customers in this state.

[10] The language of this section is identical to T.C.A. § 67-4-806(d)(2).

the State of Tennessee, even if sufficient under the Tennessee statutory scheme, do not provide a sufficient nexus under the Commerce Clause of the United States Constitution to uphold the assessment.

I.

This case presents a question regarding the limits of Tennessee's power to tax out-of-state sellers. Constitutional limitations on this power are found in both the Due Process Clause of the Fourteenth Amendment and the Commerce Clause of article 1, § 8. In the trial court, JCPNB challenged the franchise and excise taxes as a violation of both constitutional provisions. On this appeal, JCPNB has limited its question presented to consideration of whether the taxes imposed by the State of Tennessee violates the Commerce Clause. However, JCPNB also claims that the Commissioner has "blurred the line" between Due Process and Commerce Clause analysis.

Some of the Commissioner's arguments do, in fact, confuse the analysis between the Commerce Clause and the Due Process Clause. For example, in arguing that JCPNB has a substantial nexus with the State of Tennessee, the Appellee's brief states: "[JCPNB] is exercising the substantial privilege of doing business in Tennessee. On this basis, sufficient nexus exists and JCPNB is receiving the protections which establish a basis for finding of nexus." The Commissioner makes this statement after quoting a passage from *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 100 S.Ct. 1223, 63 L.Ed.2d

510 (1980).[11] However, the phrase "substantial privilege of doing business" is traditionally used in the area of due process. Additionally, the *Mobil Oil* case specifically used the language which Appellee quotes in the context of a Due Process analysis.[12] Therefore, recognizing the confusion that may exist between the parties, we find it necessary to clarify the specific limitations imposed by both Due Process and the Commerce Clause.

In *Quill Corp. v. North Dakota,* the United States Supreme Court considered the constitutional limitations on a state's power to tax imposed by both the Due Process Clause and the Commerce Clause. 504 U.S. 298, 112 S.Ct. 1904, 119 L.Ed.2d 91 (1992). The Court began by noting that the "two claims are closely related." *Id.* (quoting *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753, 87 S.Ct. 1389, 18 L.Ed.2d 505 (1967)). However, the court also pointed out that the two Clauses each pose distinct limits on the taxing power of the States. *Quill*, 504 U.S. at 305. Therefore, a State's power to tax may be sustained under the Due Process Clause, but

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[11] The quote, as it appears in Appellee's Brief states:

> The requisite "nexus" is supplied if the corporation avails itself of the "substantial privilege of carrying on business" within the State; and "[t]he fact that a tax is contingent upon events brought to pass without a state does not destroy the nexus with such a tax and transactions within a state for which the tax is an exaction.

[12] The section in which the quoted language appears begins with the following statement: "For a state to tax income generated in interstate commerce, the Due Process Clause of the Fourteenth Amendment imposes two requirements: . . . " *Mobil Oil*, 445 U.S. at 436.

imposition of the tax may nonetheless violate the Commerce Clause.[13] *Id.* (citing *Tyler Pipe Indus., Inc. v. Washington State Dept. of Revenue*, 483 U.S. 232, 107 S.Ct. 2810, 97 L.Ed.2d 199 (1987)).

II.

The due process analysis in the area of state taxation of interstate commerce derives from the rules for *in personam* jurisdiction expressed in *International Shoe Co. v. Washington*, and its progeny. 326 U.S. 310, 66 S.Ct. 154, 90 L.Ed. 95 (1945). *International Shoe*, the seminal case in the modern due process era, allows a state to assert personal jurisdiction if the defendant has minimum contacts with the jurisdiction "such that the maintenance of the suit does not offend 'traditional notions of fair play and substantial justice.' " *International Shoe*, 326 U.S. at 316 (quoting *Miliken v. Meyer*, 311 U.S. 457, 463, 61 S.Ct. 339, 343, 85 L.Ed. 278 (1940)). Subsequent cases made clear the point that physical presence in the jurisdiction is not necessary for "minimum contacts" to exist. *See, e.g., Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 105 S.Ct. 2174, 85 L.Ed.2d 528 (1985).

In the context of state taxation, the Due Process Clause "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Quill*, 504 U.S. at 306 (quoting *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 344-345, 74 S.Ct. 535, 539, 98 L.Ed. 744 (1954)). Prior to the 1967

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[13] In fact, the tax in *Quill* was struck down as violative of the Commerce Clause even though the Court found that the tax did not violate the requirements of the Due Process Clause.

decision in *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753, 87 S.Ct. 1389, 18 L.Ed.2d 505 (1967), the Supreme Court had found that "definite link" to exist in several cases involving state use taxes. However, the taxpayer in all those cases had some type of physical presence in the taxing state. *Quill* 504 U.S. at 306. The *Quill* Court noted that the *Bellas Hess* decision suggested that physical presence in the State was *necessary* to sustain jurisdiction under the Due Process Clause. *See Quill* 504 U.S. at 306-307. Applying the reasoning from the *International Shoe* and *Burger King* decisions, the *Quill* court rejected the notion that due process mandated the physical presence of an out-of-state seller before a state could tax that seller. The Court held that the Due Process Clause does not operate to bar enforcement of a use tax against a mail-order house "that is engaged in continuous and widespread solicitation of business within a state." *Quill*, 504 U.S. at 308. In other words, if the contacts were sufficient to subject the corporation to personal jurisdiction in the forum state, then imposition of a use tax on the corporation's business in the state would be sustained in the face of a Due Process challenge. Physical presence in the state is not necessary. In so holding, the *Quill* Court noted the policy concerns that drive due process analysis. Specifically, the Court stated:

> Due process centrally concerns the fundamental fairness of governmental activity. Thus, at the most general level, the due process nexus analysis requires that we ask whether an individual's connections with a State are substantial enough to legitimate the State's exercise of power over him. We have, therefore, often

> identified "notice" or "fair warning" as the analytic touchstone of due process nexus analysis.

Quill, 504 U.S. at 312.

In the present case, the National Bank's relationship with the State of Tennessee was such that the imposition of the franchise and excise taxes was not precluded by due process considerations. The lack of a physical presence in Tennessee does not mandate a finding to the contrary. The following passage from *Burger King Corp. v. Rudzewicz*, cited by the *Quill* Court, is equally applicable in the present case.

> Jurisdiction in these circumstances may not be avoided merely because the defendant did not physically enter the forum State. Although territorial presence frequently will enhance a potential defendant's affiliation with a State and reinforce the reasonable foreseeability of suit there, it is an inescapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communications across state lines, thus obviating the need for physical presence within a State in which business is conducted. So long as a commercial actor's efforts are 'purposefully directed' toward residents of another State, we have consistently rejected the notion that an absence of physical contacts can defeat personal jurisdiction there.

Burger King, 471 U.S. at 476. JCPNB has reached out to the citizens of the State of Tennessee through the solicitations for credit cards that were sent on its behalf. Moreover, JCPNB has purposefully availed itself of the substantial privilege of doing business in the State of Tennessee. *See id.* Clearly, the franchise and excise taxes assessed against

JCPNB are not violative of the rights guaranteed under the Due Process Clause.

The Due Process Clause, however, is only the first consideration in determining whether a state may tax an out-of-state seller. Having recognized that the Due Process Clause does not preclude imposition of the franchise and excise taxers on JCPNB, we must consider the limitations imposed by the Commerce Clause.

III.

The Commerce Clause expressly authorizes Congress to "regulate Commerce with foreign Nations, and among the several States." U.S. CONST. art. I, § 8, cl. 3. In addition to this affirmative grant of power, the "negative" or "dormant" Commerce Clause also serves to prohibit state actions that interfere with interstate commerce. *See Quill*, 504 U.S. at 309 (citing *South Carolina State Highway Dept. v. Barnwell Bros., Inc.* 303 U.S. 177, 185, 58 S.Ct. 510, 514, 82 L.Ed. 734 (1938)). Simply stated, the fact that the Commerce Clause grants Congress the specific power to regulate interstate commerce necessarily carries the negative implication that the states may not act to interfere with interstate commerce.

The earliest cases in this area strictly limited the state's rights to tax interstate sales. *See, e.g., Leloup v. Port of Mobile*, 127 U.S 640, 648, 8 S.Ct. 1380, 1384, 32 L.Ed. 311 (1888) ("no state has the right to lay a tax on interstate commerce in any form"). Subsequent decisions by the Court moved away from the absolute limits imposed on state taxation and began to distinguish between "direct" and "indirect" burdens on interstate commerce. This line

of cases culminated with the decision in *Freeman v. Hewit*, 329 U.S. 249, 67 S.Ct. 274, 91 L.Ed.265 (1946), in which the Court formally embraced the distinction and struck down an Indiana tax as a direct tax on interstate sales.

Dormant Commerce Clause jurisprudence in the area of state taxation changed dramatically with the decision in *Complete Auto Transit. Inc. v. Brady*, 430 U.S. 274, 97 S.Ct. 1076, 51 L.Ed.2d 326 (1977). The *Complete Auto* decision rejected the line of cases which had held impermissible the direct taxation of interstate commerce by the states.[14] *Complete Auto* enunciated a four-part test, which provided that a state tax on an out-of-state seller will be sustained so long as the "tax (1) is applied to an activity with a substantial nexus with the taxing state, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services provided by the state." *Complete Auto Transit, Inc.* 430 U.S. at 279.

The question in the present case is whether JCPNB's relationship with the State of Tennessee satisfies the "substantial nexus" requirement found in the first prong of the *Complete Auto* test. That question, in turn, raises the question of what is meant by the term "substantial nexus." As an initial matter, we can say that substantial nexus under the Commerce Clause is not the same as minimum contacts under the Due Process Clause. *See Quill*, 504 U.S. at 313 ("Thus, the 'substantial nexus' requirement is not, like due process' 'minimum contacts'

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[14] As stated in *Quill*, the *Complete Auto* decision "renounced the *Freeman* approach as 'attaching constitutional significance to a semantic difference.' " *Quill*, 504 U.S. at 310.

requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce"). Although stating that proposition in the abstract seems to be simple enough, the actual analysis can be much more confusing. The problem is that phrases such as "minimum contacts" and "substantial nexus" do not really mean anything. There is no definitive line that marks a minimum contact, nor is there a specific point at which a substantial nexus exists. The analysis in this area is necessarily done on a case-by-case basis. However, we are guided by the recognition that the Commerce Clause imposes a greater limitation on Tennessee's right to tax JCPNB than does the Due Process Clause. With the distinctions between the two clauses in mind, we turn to the question of whether a substantial nexus exists to sustain the franchise and excise taxes imposed by the Commissioner.

IV.

We do not consider the fact that JCPNB was "doing business" in Tennessee to be dispositive of the present issue. If that were the case, we would have obliterated the distinction between the Due Process Clause and the Commerce Clause. Instead, we must attempt to delineate that level of "presence" in the State of Tennessee that will justify the imposition of the types of taxes that are the subject of this appeal. This "presence" must, in order to satisfy the Commerce Clause, be more than merely "doing business" in the State of Tennessee. JCPNB relies on *Bellas Hess* and *Quill* to argue that physical presence is required. The Commissioner, on the other hand, argues that physical presence is not a formal requirement and

the validity of a state tax should be determined under the *Complete Auto* test. The Commissioner refers to this as "contemporary Commerce Clause jurisprudence." The fundamental flaw in the Commissioner's argument is that *Complete Auto* does not set a different standard than that contemplated in *Bellas Hess* and *Quill*. Rather, *Bellas Hess* and *Quill* specifically address the first prong, or the substantial nexus requirement, of the *Complete Auto* test. *See quill*, 504 U.S. 311. In that regard, the *Bellas Hess/Quill* decisions are entirely consistent with the *Complete Auto* test. Both *Bellas Hess* and *Quill* are clear in their holding that in the context of a use tax, physical presence is required in order to satisfy the substantial nexus requirement of *Complete Auto*.

The only real issue is whether there is any reason to distinguish the present case from *Bellas Hess* and *Quill*. The Commissioner argues that those cases are distinguishable because they involved use taxes, whereas the present case involves franchise and excise taxes. We must reject the Commissioner's argument. While it is true that the *Bellas Hess* and *Quill* decisions focused on use taxes, we find no basis for concluding that the analysis should be different in the present case. In fact, the Commissioner is unable to provide any authority as to why the analysis should be different for franchise and excise taxes.[15] It is certainly true that the *Quill* court expressed some reservations about the vitality of the *Bellas Hess* decision. *See*

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[15] The Commissioner's brief merely states that it is JCPNB's burden to show why the *Bellas Hess* rule should be followed in the present case and that they have failed to meet that burden.

Quill, 504 U.S. at 311 (stating that the *Bellas Hess* decision might be different were the issue to arise for the first time today). However, we are not in a position to speculate as to how the Supreme Court might decide future cases. We are only able to rely on past decisions. Any constitutional distinctions between the franchise and excise taxes presented here and the use taxes contemplated in *Bellas Hess* and *Quill* are not within the purview of this court to discern. As such, we feel that the outcome of this case is governed by *Bellas Hess* and *Quill*, as those decisions interpret the first prong of the *Complete Auto* test.

JCPNB argues that the present case is "almost identical" to the facts in *Quill*. In many respects, that assertion is correct. JCPNB is a Delaware corporation with no offices or agents in Tennessee, just as the taxpayer in *Quill* had no offices or employees in North Dakota. *See Quill*, 504 U.S. at 302. Also, JCPNB did not physically engage in any activities in Tennessee connected with its credit card business. Similarly, Quill solicited business in North Dakota through catalogs, flyers, and other advertisements and delivered those goods via mail or common-carrier, thereby having no physical presence in North Dakota. *Id.*

In response to JCPNB, the Commissioner asserts several arguments in support of finding that JCPNB does, in fact, have a substantial nexus with Tennessee. First, she argues that the credit cards which JCPNB issued were tangible physical property over which JCPNB maintained ownership, thereby giving JCPNB a physical presence in

Tennessee through those cards.[16] Additionally, she argues that the presence of the J.C. Penney retail stores in Tennessee provides the requisite substantial nexus. We will deal with each of these arguments in turn.

During the tax years in question, JCPNB had between 11,000 and 17,000 accounts with Tennessee residents. The chancellor found that the actual credit cards constituted "tangible property for substantial nexus purposes." In reaching that decision, the chancellor found it persuasive that the cards remained the property of JCPNB. While we agree that a credit card is tangible in that it can be seen and touched, we do not agree that the presence of the credit cards in Tennessee is constitutionally significant. Additionally, we do not find it relevant that JCPNB retained ownership of the cards.

Credit cards, in and of themselves, are virtually worthless. The "value" of these cards is found in the right which the card represents, namely the credit account. The card is merely representative of the customer's right to charge goods and services. The actual card is not even necessary to the transaction.[17] It merely serves as a

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[16] In making this argument, we do not understand the Commissioner to concede that physical presence is *necessary* for a finding of substantial nexus.

[17] While it may be common practice to physically present the card when making a purchase, that fact seems to be more of a practical requirement than anything else. The card contains information which identifies the account-holder. Perhaps, it would be much simpler and cost-effective to assign a cardholder his or her account number and allow purchases to be made simply by the verbal recitation of that account number. However, such a procedure would beg problems. There would

convenient article on which to record the necessary information regarding the customer's account. As the chancellor correctly determined, the real asset is the intangible account which the card represents. Those accounts were located, for tax purposes, in the State of Delaware and not subject to a Tennessee tax. Therefore, we do not agree with the chancellor's determination that the physical presence of the JCPNB credit cards constituted a basis for finding substantial nexus.[18]

The Commissioner also argues that JCPNB had a physical presence in Tennessee by virtue of the fact the J.C. Penney Company, JCPNB's parent, owned and operated the J.C. Penney retail stores in Tennessee. This argument lacks merit because the retail stores were not affiliated with JCPNB's Visa and MasterCard credit card operations.[19] The retail stores conducted no activities

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be no way to determine whether the person presenting the account number is, in fact, the authorized user. It is certainly conceivable that the cards exist merely to prevent fraud or unauthorized usage.

[18] Contrary to the chancellor's decision, we find it constitutionally insignificant that the credit cards remained the property of JCPNB. It seems entirely reasonable that the retained ownership merely gave JCPNB the right to end the credit relationship with a customer. After the relationship ended, the actual cards were of little or no value to JCPNB, therefore making ownership of no consequence. In fact, evidence in the record indicates that cards that have been returned by customers are destroyed.

[19] We note that many of the potential customers for JCPNB credit cards were identified through a list of individuals who had a previous credit history with the J.C. Penney Company. We summarily reject the argument that this was sufficient to provide a substantial nexus. There is no evidence to show that

which assisted JCPNB in maintaining its credit card business in Tennessee. The record shows that one could not apply for the JCPNB credit cards at the J.C. Penney retail stores, nor could individuals make a payment on their Visa or MasterCard account at the retail stores. Therefore, we reject the Commissioner's arguments which contend that a substantial nexus exists based on the presence of the J.C. Penney retail stores in Tennessee.

Finally, the chancellor concluded that a substantial nexus existed based on "the activities of the affiliates and third parties working on JCPNB's behalf." In reaching this conclusion, the chancellor relied on *Tyler Pipe Indus. v. Washington State Dep't of Rev.*, 483 U.S. 232, 107 S.Ct. 2810, 97 L.Ed.2d 199 (1987) and *Scripto v. Carson*, 362 U.S. 207, 80 S.Ct. 619, 4 L.Ed. 2d 660 (1960). We are unable to agree with the chancellor's reasoning. Both *Tyler Pipe* and *Scripto* involved one crucial element which is absent in the present case. In those cases, activities were being conducted in the taxing state that substantially contributed to the taxpayer's ability to maintain operations in the taxing state. Simply put, the taxpayer in those cases

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the retail stores had anything to do with this information. Every indication is that the J.C. Penney company conducted all of these activities from its corporate offices in Texas. Moreover, JCPNB also obtained the names of potential customers through independent credit reporting agencies. We find no basis for concluding that the use of credit information subjects the user of that information to a tax in the provider's home state. Under this theory, JCPNB would be subject to a tax in any state in which a credit reporting agency with whom JCPNB dealt was located. We believe this theory exemplifies the very sort of state taxation of interstate commerce that the Commerce Clause serves to prevent.

had a physical presence in the taxing state that is lacking in the present case.

In *Scripto*, the Georgia taxpayer employed independent contractors who solicited business in the State of Florida, the taxing state. *See Scripto*, 362 U.S. at 211 ("Each salesman . . . is actively engaged in Florida as a representative of Scripto for the purpose of attracting, soliciting and obtaining Florida customers"). The real issue in *Scripto* was whether it made any constitutional difference that the individuals hired to solicit business were employed as "independent contractors" rather than as regular employees. The court refused to find any meaningful difference between the labels used to describe the employees. *See id.* at 211 (holding the distinction between regular employees and independent contractors to be without constitutional significance).

Similarly, in *Tyler Pipe*, the Supreme Court found that a substantial nexus existed to justify the imposition of a business and occupation tax by the State of Washington.[20] In *Tyler*, the solicitation was "directed by executives who maintain their offices out-of-state and by an *independent contractor located in Seattle.*" *Tyler Pipe*, 483 U.S. at 249 (emphasis added). The Court, agreeing with the Washington Supreme Court, found the crucial factor to be the fact that the activities which allowed the taxpayer to establish and maintain a market actually took place *in the State of*

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[20] The Supreme Court actually vacated the judgment and remanded the case to the state court based on an issue unrelated to the question of substantial nexus.

Washington. *Id*. at 250 (emphasis added). The Court concluded by stating, "the activities of Tyler's sales representatives adequately support the State's jurisdiction to impose its wholesale tax on Tyler." *Id*. at 251. Here, as in *Scripto*, the distinguishing factor was the physical presence of the taxpayer in the taxing state.

A review of the facts of the present case convinces this court that JCPNB did not have a physical presence in Tennessee through its affiliates. Neither BSI nor MBNA actually performed any services on behalf of JCPNB in the State of Tennessee. The solicitation, which was the most important function in allowing JCPNB to maintain its business, took place through the U.S Mail, which, under the holding in *Quill*, does not allow a finding of substantial nexus. In short, the activities which allowed JCPNB to conduct its credit card operation did not occur in the State of Tennessee.[21] As such, we believe the chancellor's reliance on *Scripto* and *Tyler Pipe* was misplaced as those cases are clearly distinguishable.

It is not our purpose to decide whether "physical presence" is required under the Commerce Clause. However, the Commissioner has pointed to no case in which

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[21] There is an indication in the record that one of JCPNB's affiliates used a Tennessee collection agency in order to recover moneys owed to JCPNB. Apparently, these collection efforts were aided through the use of the Tennessee court system. This may be the closest that JCPNB comes to having a physical presence in Tennessee. However, we do not believe that the actions of a party so far removed from JCPNB are sufficient to allow the State of Tennessee to levy taxes on JCPNB. The relationship is far too attenuated to confer a physical presence on JCPNB.

the Supreme Court of the United States has upheld a state tax where the out-of-state taxpayer had absolutely no physical presence in the taxing state. The Commerce Clause requires a greater relationship than does the Due Process Clause. If we were to uphold the tax assessment against JCPNB, we believe that we would be unjustifiably overlapping the two clauses. While we are confident that the tax assessment satisfies due process, we failed to see the substantial nexus necessary to sustain the tax under the Commerce Clause. *Scripto, Inc. v. Carson*, is, by the Supreme Court's own words, the furthest extension of a state's right to tax an out-of-state seller. However, *Scripto* involved facts that are not present in this case. Specifically, the Georgia company in *Scripto* employed individuals in the State of Florida, the taxing state, to solicit business. Therefore, if *Scripto* is the furthest reach of a state's power to tax, and there is even less of a relationship in this case than was present in *Scripto*, we conclude that a substantial nexus is lacking to uphold the tax assessment against JCPNB.

Conclusion

For the reasons stated herein, we reverse and dismiss the decision of the trial court, which upheld the imposition of franchise and excise taxes against JCPNB. Costs of this appeal are taxed to the appellee, Ruth E. Johnson,

Commissioner of Revenue, State of Tennessee, for which execution may issue if necessary.

/s/ Highers
HIGHERS, J.

CONCUR:

/s/ Farmer
FARMER, J.

/s/ Holly K. Lillard
LILLARD, J.

IN THE COURT OF APPEALS OF TENNESSEE AT NASHVILLE

J.C. PENNEY NATIONAL BANK,	**Davidson Chancery No. 96-276-I**
Plaintiff/Appellant,	**Appeal No.** M1998-00497-COA-R3-CV
VS.	
RUTH E. JOHNSON, Commissioner of Revenue, State of Tennessee,	
Defendant/Appellee.	

JUDGMENT

(Filed Dec. 17, 1999)

This cause came on to be regularly heard and considered by the Court on the record, and for the reasons stated in the Opinion of this Court filed this date, it is ORDERED that:

1. The judgment of the trial court is reversed and dismissed.

2. Costs are adjudged against the appellee, Ruth E. Johnson, Commissioner of Revenue, State of Tennessee, for which execution may issue if necessary.

/s/ Highers
HIGHERS, J.

/s/ Farmer
FARMER, J.

/s/ Holly K. Lillard
LILLARD, J.

IN THE SUPREME COURT OF TENNESSEE
AT NASHVILLE

J.C. PENNEY NATIONAL BANK v. RUTH E. JOHNSON, COMMISSIONER OF REVENUE, STATE OF TENNESSEE

Chancery Court for Davidson County
No. 96-276-1

No. M1998-00497-SC-R11-CV

ORDER

(Filed May 8, 2000)

Upon consideration of the application for permission to appeal of Ruth E. Johnson, Commissioner of Revenue, State of Tennessee, and the record before us, the application is denied.

PER CURIAM

IN THE CHANCERY COURT FOR THE STATE OF TENNESSEE TWENTIETH JUDICIAL DISTRICT, DAVIDSON COUNTY, PART I

JCPENNEY NATIONAL BANK,	)	
Plaintiff,	)	
v.	)	**No. 96-276-1**
RUTH E. JOHNSON, Commissioner of Revenue State of Tennessee,	)	
Defendant.	)	

MEMORANDUM AND ORDER

(Filed Oct. 16, 1998)

This matter comes before the Court under the provisions of T.C.A. §67-1-1801 wherein JCPNB seeks an abatement of franchise and excise taxes assessed by Defendant in connection with JCPNB's credit card business. The taxes were assessed for the 1990 through 1994 tax years. JCPNB, an out-of-state bank with its principle place of business in Delaware, argues that the franchise and excise taxes assessed to it are Commerce Clause and Due Process violations. Upon careful review of the record, this Court affirms the Defendant's assessment of the taxes and finds that JCPNB does have sufficient nexus with Tennessee to satisfy Commerce Clause requirements. Further, this Court finds that Tennessee's apportionment formula as applied to JCPNB meets Due Process standards.

STANDARD OF REVIEW

Tax assessments are presumed to be valid. *Stratton v. Jackson*, 707 S.W.2d 865, 867 (Tenn. 1986); *Ace of Clubs v. Huddleston*, 872 S.W.2d 679, 681 (Tenn. App. 1993). The Commissioner of Revenue is presumed to be correct and unless error is shown by clear and convincing evidence, the Court will not disturb the Commissioner's assessment. *Edmonson Mgt. Serv., Inc. v. Woods*, 603 S.W.2d 716 (Tenn. 1980). In challenges issued to Tennessee's tax apportionment formulas, clear and cogent evidence is the standard. This standard is more than a preponderance of the evidence. *See Gray v. Todd*, 819 S.W.2d 104, 108 (Tenn. App. 1991). It need not, however, be uncontradicted, *see Alexander v. C.C. Powell Realty Co.*, 535 S.W.2d 154, 158 (Tenn. App. 1975), and it need not remove all reasonable doubt. *See In re Estate of Wardell*, 674 S.W.2d 293, 295 (Tenn. App. 1983).

FINDINGS OF FACT

Plaintiff, JCPenney National Bank ("JCPNB"), is a Delaware corporation which has its principal place of business in Harrington, Delaware. JCPNB is a federally chartered national banking association engaged in consumer banking. JCPNB is also a member of the Visa USA credit card network and the MasterCard International credit card network. JCPNB has no offices, branches or employees in Tennessee.

During the years 1990 to 1993, JCPNB had, on an annual basis, between 11,535 and 17,725 credit card

accounts with Tennessee customers. These accounts produced finance charge revenues of approximately $2 million annually. The total of the balances for the JCPNB's Tennessee credit card accounts averaged approximately $11 million at year-end for each of the tax years at issue.

JCPNB has contracted with its parent company, affiliates and third parties to provide certain services in connection with its credit card business. JCPNB is a member of the Visa and MasterCard network which serves as a clearinghouse for credit card transactions through its role in credit purchase authorization, transaction processing and transaction settlement. The processing of the credit card transactions is handled by Maryland Bank National Association ("MBNA"), an unrelated entity and the processing of payments and collections are handled by JCPenney Credit Services, an affiliate. The Visa/MasterCard headquarters, MBNA and JCPenney Credit Services are located outside of Tennessee.

The solicitation of new credit card customers for JCPNB is handled by its parent company, JCPenney Company ("JCPenney Co."). During the years at issue, JCPenney Co. in turn outsourced the marketing and solicitation responsibilities to its affiliate, JCPenney Business Services, Inc. ("BSI"). BSI has no offices or employees located in Tennessee.

In order to compile a mailing list of potential JCPNB credit card customers in Tennessee, BSI would determine the Tennessee residents who possessed "proprietary" credit cards for use only at JCPenney retail stores. BSI would then submit these customer names to Equifax, (a

national credit bureau with headquarters outside Tennessee), for rating according to JCPNB selected criteria. Equifax, through local affiliates, would then determine if the Tennessee customers met with JCPNB's credit criteria and from there forward the list to BSI. BSI would then solicit credit card account applications from these pre-screened Tennessee customers through the U.S. mail.

The completed application is forwarded to an MBNA subsidiary (SSBA) located outside of Tennessee which then sets up an account with the MBNA computer database. Cards are then issued to the customer bearing a Visa or MasterCard logo. The back side of these cards contain magnetic strips which state the cardholder's account number, name and card expiration date. The customer's agreement with JCPNB states that the card remains the property of JCPNB and may be recalled by JCPNB or returned by the cardholder for any reason.

As mentioned earlier, JCPenney Credit Services Division handles the credit servicing functions on behalf of JCPNB. This includes the establishment and maintenance of a toll free line for JCPNB card holders who have questions about their accounts. Should a Tennessee cardholder with a delinquent account need credit counseling, the Services Division will recommend that he/she contact the Consumer Credit Counseling Services (CCCS) offices in Tennessee. CCCS assesses a fee for its services to JCPNB cardholders and JCPNB voluntarily pays those fees. JCPenney Credit Services also handles the collection responsibilities for those JCPNB customers with delinquent accounts. In the event that there were outstanding delinquent Tennessee accounts, JCPenney Credit Services would assign that account to a collection agency. Upon

recommendation by these collection agencies, JCPenney Credit Services approves litigation of certain accounts. JCPNB has used Tennessee courts to litigate in support of its collection efforts for its Tennessee customers.

With respect to credit card transactions, the following steps generally occur. The customer presents the credit card to a merchant who is a member of Visa and/or MasterCard Services for the purchase. The merchant swipes the card through a point of sale terminal which reads the magnetic strip on the credit card and electronically transmits a request for authorization via telephone. The authorization is first transmitted to the merchant bank[1], and from the merchant bank to Visa or MasterCard central locations. From there, the authorization request is transmitted to the issuing bank (JCPNB) or its processor (MBNA/SSBA). When SSBA receives an authorization request, it determines whether the customer's JCPNB account is in good standing. If so, SSBA will return authorization of the transaction on behalf of JCPNB via the same electronic transmission process. The transmission goes back through Visa/MasterCard, to the merchant bank and then finally to the merchant. This electronic authorization process is completed in a matter of seconds and, if approved, the customer is able to make the credit purchase and receive the goods at the merchant's location.

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[1] A merchant bank contracts with a merchant to process the credit card transactions on behalf of its merchant customers. The bank agrees to accept the charge slips resulting from Visa or MasterCard credit card purchases and deposits them into the merchant's account.

With the JCPNB credit card, customers can also obtain cash advances from local and out-of-state banks and automated teller machines ("ATMs") that accept Visa or MasterCard or the "Cirrus" logo. The process involved in these transactions is similar to the authorization process for credit card purchases. Once the credit card with the Visa or MasterCard logo is entered into an ATM or presented to a bank, authorization for the case disbursement passes through Visa/MasterCard to SSBA and then back to the bank or ATM machine being used by the credit card holder.

JCPNB was audited by the Tennessee Department of Revenue in 1995. The Department of Revenue issued an assessment to JCPNB in the total amount of $178,314.00 for the tax years 1990 through 1994. This figure included franchise and excises taxes in the amount of $111,725.00, a penalty of $27,932.00 and interest of $38,657.00. The taxes were assessed using a single factor apportionment formula. JCPNB has never filed a franchise or excise tax return with the Tennessee Department of Revenue and has never paid any franchise or excise taxes to Tennessee.

ISSUES PRESENTED

JCPNB presents the following issues to this Court for review:

I. Whether the State of Tennessee, consistent with the Commerce Clause of the federal Constitution, may levy franchise and excise taxes on JCPNB's credit card business activities in Tennessee.

II. Whether the imposition of franchise and excise taxes based upon the single factor receipts apportionment formula violates the Due Process Clause of the United States Constitution.

CONCLUSIONS OF LAW

I. Commerce Clause

In Tennessee, franchise and excise taxes are assessed for the substantial privilege of carrying on business within the state. Financial institutions are subject to these taxes through T.C.A. §67-4-804(7), § 67-4-806 and §67-4-903. JCPNB does not contest that its credit card business activities in Tennessee come within the terms of these statutory provisions since it regularly solicits business from customers in Tennessee, provides credit card services to its customers and engages in transactions in which it extends credit to these customers and receives interest income and fee income from these transactions and loans. Rather, JCPNB argues that because it is an out-of-state financial institution with no branches, offices or employees located within Tennessee, it has an insufficient nexus with Tennessee for Commerce Clause purposes.

JCPNB asks this Court to take the position that before a constitutional nexus can be found to exist between Tennessee and the entity it seeks to tax, that entity needs to have a physical presence within Tennessee. This Court declines to accept this "physical presence" requirement in this case.[2] The test applied to determine whether a state

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[2] JCPNB argues that the *Quill Corp. v. North Dakota* physical presence standard should be applied to franchise and excise

tax will be deemed constitutional was articulated by the Supreme Court in *Complete Auto Transit, Inc. v. Brady* and consists of the following four prongs:

1) The tax must be applied to an activity with a substantial nexus with the taxing state;

2) The tax must be fairly apportioned;

3) The tax must not discriminate against interstate commerce; and

4) The tax must be fairly related to benefits and services provided by the State.

430 U.S. 274, 279, 97 S.Ct. 1076, 1079 (1977).

In articulating these four requirements, the Supreme Court adopted a standard wherein state taxes would be judged based on their practical effects and the economic realities of their application rather than formal legal terminology. *See* 430 U.S. at 279, 97 S.Ct. at 1079. The Court in *Complete Auto* noted that although there had been some inconsistency in past decisions regarding certain types of

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taxes. 504 U.S. 298, 112 S.Ct. 1904 (1992). *Quill* requires the physical presence of an out-of-state business within the taxing state before a use tax could be imposed on that business. In other words, physical presence of the taxpayer in the taxing state needs to exist before a substantial nexus can be found with that state. Upon careful review of *Quill*, this Court finds that the physical presence requirement is inapplicable to this case. In discussing the validity of the physical presence test, the Supreme Court made careful note that although physical presence was not a requirement as to other state taxes, it did not mean that mandating physical presence was not valid in use tax situations. This Court does not interpret *Quill* as a Supreme Court implication that the physical presence requirement should be extended to other state tax assessments.

taxes, it has consistently indicated that it "was not the purpose of the Commerce Clause to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing business." *Complete Auto*, 430 U.S. at 288, 97 S.Ct. at 1079.

The first prong of the *Complete Auto* test – "substantial nexus" – concerns whether there exists a sufficient connection between the taxing state and the taxpayer's business activities within that state.[3] In determining whether an out of state business without employees or offices within the taxing state has sufficient nexus with that state, the Supreme Court has determined that a critical factor for consideration is whether the activities performed in the state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market for its in-state sales. *Tyler Pipe Inds. v. Dept. of Revenue*, 483 U.S. 232, 250; 107 S.Ct. 2810, 2821 (1987).

JCPNB asks that this Court use an "agency" analysis when considering the nature of the third party activities performed on its behalf. JCPNB uses the concept of agency as defined by Tennessee law to assert that JCPNB

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[3] Although the *Complete Auto* Court was unclear as to what particular circumstances would satisfy "substantial nexus", subsequent cases by the Supreme Court and other state courts have indicated that this prong would be satisfied by not only physical presence, but also tangible and/or intangible property located within the state. Absent these particular factors, an analysis of the relationship between the activity taxed and the taxpayer's contacts with the taxing state would be necessary to determine sufficient nexus.

would need to exercise "control" over these third parties before this Court can analyze these relationships for nexus. This Court does not agree that a formal agency relationship needs to be established in order to analyze the relationships between JCPNB and the third parties contracted with. To do so would undermine the principles espoused by the Supreme Court in *Tyler* and *Scripto Inc. v. Carson*, 362 U.S. 207, 80 S.Ct. 619 (1960).

Tyler concerned Washington state's imposition of a business and occupation tax on an out-of-state manufacturer with no employees or property in the taxing state and whose solicitation of in state business was handled by third parties. As a matter of law, the Washington Supreme Court concluded that a showing of a sufficient nexus could not be defeated by the argument that the taxpayer's representative was properly characterized as an independent contractor instead of as an agent. The Supreme Court agreed with this analysis and cited its ruling in *Scripto, Inc. v. Carson*, 362 U.S. 207, 80 S.Ct. 619 (1960). Scripto, a Georgia corporation, had no offices or regular employees in Florida but it employed wholesalers or jobbers to solicit sales of its products in Florida. The Court held that Florida may require these solicitors to collect a use tax from Florida customers. Although the solicitors were not actual employees of Scripto, the Court determined that "such a fine distinction is without constitutional significance." *Id.* at 211, 80 S.Ct. at 621.

This Court will analyze the relationships at issue using the standard set forth in *Tyler*. The nexus inquiry will focus on the types of activities performed on JCPNB's behalf which may not be subject to its direct control. In the instant case, the activities of the affiliates

and third parties working on JCPNB's behalf satisfy the first prong of *Complete Auto*.

JCPNB relies on its affiliate JCPenney retail stores to provide names of potential customers. The record indicates that 95% of the Tennessee customers targeted for credit card solicitation come from lists provided by the Tennessee JCPenney retail stores. The active soliciting done by BSI of these pre-screened accounts obtained from in-state sources contribute significantly to the establishment of JCPNB's credit card business within Tennessee.

JCPenney Credit Services Division's activities on behalf of JCPNB also aid JCPNB in the maintenance of its customers within the state. The Credit Services Division provides a toll free number for cardholder questions, contacts Tennessee customers who are delinquent in their accounts, refers customers to a local credit counseling services (CCCS) (whose fees were paid directly by JCPNB), and assigns accounts to a collection agency. All these services performed by the Credit Services Division and CCCS on behalf of JCPNB are vital to the maintenance of JCPNB's active credit card customer accounts.

JCPNB argues, in the alternative, that it has no tangible or intangible property located in Tennessee that would equate to substantial nexus for Commerce Clause purposes.

JCPNB correctly argues that the JCPNB accounts receivables generated by its credit card business activity are not intangible property located in Tennessee for nexus purposes. JCPNB asserts that the situs for such intangibles is the taxpayer's domicile, in this case Delaware. JCPNB cites *Grundy County v. Tennessee Coal Co.*, 94 Tenn.

295 (1895), which held that for tax assessment purposes, intangible property not specifically addressed by the legislature have a situs at the domicile of the owner. Although later Supreme Court decisions have allowed for a more flexible analysis in determining a taxpayer's business situs, the holding in *Grundy* still stands. Subsequent acts passed by this state's legislature concerning the taxation of financial institutions have not indicated otherwise. Thus, the situs of JCPNB's intangible property is located in Delaware.

However, JCPNB has tangible property, in the form of its credit cards, located in Tennessee. During the tax years in question, JCPNB had between 11,000 and 17,000 accounts with Tennessee residents. The records indicates that by 1993, JCPNB had 17,725 accounts within the state. The issuance of over 17,000 JCPNB credit cards within Tennessee that the customer and JCPNB agree are the property of JCPNB, are tangible property for substantial nexus purposes. JCPNB contends that even if the JCPNB credit cards are considered tangible property, they constitute only a slight presence within the state. JCPNB bases this claim on the facts in *Quill v. North Dakota*, 504 U.S. 298, 112 S.Ct. 1904 (1992). The Supreme Court stated that the title Quill held to a few diskettes within the state did not constitute sufficient nexus. *Id.* at 314, 112 S.Ct. at 1914. JCPNB's argument is without merit. In the instant case, the issuing and use of over 17,000 JCPNB credit cards within Tennessee are considerably more than the few diskettes at issue in *Quill* and do not constitute a "slight presence."

JCPNB argues further that this Court's prior decision in *Barnes & Noble Superstores, Inc. v. Huddleston*, No.

94-2778-III(II) (Tenn Ch. Court, Davidson Co. 1/3/96) holds that plastic cards bearing an individual's name and identification number are not tangible property per se. JCPNB's argument is not persuasive. The facts and underlying issues in *Barnes & Noble* can be distinguished from the instant case. In *Barnes & Noble*, the issue was whether a membership card entitling the purchaser to discounts on bookstore merchandise constituted a sale of tangible personal property for sales tax purposes. In the instant case, the issue is whether credit cards present in the Tennessee are tangible personal property for constitutional nexus purposes. This Court's holding in *Barnes & Noble* is not dispositive when applied to the facts before this Court.

Rather, in determining whether the credit cards themselves are tangible physical property, this Court finds it significant that the JCPNB credit card is contractually agreed upon by both JCPNB and the customer prior to its issuance to be the personal property of JCPNB. The credit cards remain the property of JCPNB while the Tennessee customer has an active account with JCPNB and must be surrendered to JCPNB if it so demands. Thus, the JCPNB credit cards within the state are tangible property that create a sufficient nexus with Tennessee.

The second prong of the *Complete Auto* test dealing with the internal and external consistencies of the tax has not been challenged by JCPNB and will not be addressed in this Memorandum.

The third prong of *Complete Auto* requires that the tax not impose greater burdens on interstate commerce than

that imposed on commerce occurring within the state. The franchise and excise taxes assessed against JCPNB satisfy this prong. JCPNB's contention that there is some discriminatory impact with respect to the single receipts formula favoring in state businesses with out-of-state sales over out-of-state businesses within in state sales, is unsupported by the record. JCPNB has offered no evidence of the tax advantages enjoyed by in state financial institutions. The Tennessee franchise and excise taxes applicable to all financial institutions take into account only the income generated from their activities within Tennessee.

The fourth prong of *Complete Auto* requires only that the measure of the tax be reasonably related to the extent of the taxpayer's contact with the state. 430 U.S. at 622, 97 S.Ct. at 1083. JCPNB does not contest that Tennessee's franchise and excise taxes are not rationally related to its activities within the state, nor does it contest that it reaps financial benefits from doing business in Tennessee. Thus, Tennessee's franchise and excise tax satisfy this last prong of *Complete Auto*.

II. Due Process

JCPNB also argues that the apportionment formula for franchise and excise taxes violates of the Due Process clause. JCPNB's argument revolves around Tennessee's single factor receipts formula used to tax financial institutions. Both the franchise and excise taxes are based on a ratio of the taxpayer's business receipts in Tennessee to its receipts in all states. This "single factor" ratio determines the percentage of taxpayer's income which will be

apportioned to Tennessee. JCPNB contends that this apportionment formula does not fairly represent its activities within Tennessee.

Due process requires a "rational relationship between the income attributed to the state and the intrastate values of the enterprise." *Mobil Oil Corp. v. Comm'r of Taxes of Vermont*, 445 U.S. 425, 436-437, 100 S.Ct. 1123, 1231 (1980). Also, the inquiry focuses on "whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state." *State of Wisconsin v. JCPenney Co.*, 311 U.S. 435, 444, 61 S.Ct. 246, 250 (1940).

Tennessee's tax satisfies these Due Process principles. It has been demonstrated that JCPNB receives benefits from doing business in Tennessee and that general government services established in the state facilitate JCPNB's credit card business. JCPNB avails itself of the State's courts in order to litigate delinquent accounts. This is one of the "privileges of living in an organized society"[4] which benefits JCPNB's credit card business.

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[4] The Supreme Court has rejected the argument that the services provided by the state to the individual taxpayer must correspond directly to the amount of the tax imposed:

> A tax is not an assessment of benefits. It is, as we have said, a means of distributing the burden of the cost of government. The only benefit to which the taxpayer is constitutionally entitled is that derived from his enjoyment of the privileges of living in an organized society, established and safeguarded by the devotion of taxes to public purposes. Any other view would preclude the levying of taxes except as they are used to compensate for the burden on those who pay them,

However, a tax will constitute a violation of Due Process if it is "out of all appropriate proportion to the business transacted," *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123, 135, 51 S.Ct. 385, 389 (1931), or if the tax has "led to a grossly distorted result." *Moorman Mfg. Co. v. Bair*, 437 U.S 267, 98 S.Ct. 2340, 2341 (1978). JCPNB asserts that the use of the single factor formula rather than a three-factor apportionment formula[5] results in a 300% increase in taxable income attributed to JCPNB. JCPNB argues that this constitutes a "gross distortion" impermissible under Due Process standards.

JCPNB's argument is without merit. Single factor apportionment formulas based on gross receipts have been found to meet both Due Process and Commerce Clause standards. *Moorman*, 437 U.S. 267, 98 S.Ct. 2340. The single factor formula as applied in this case taxes

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> and would involve abandonment of the most fundamental principle of government – that it exists primarily to provide for the common good.

Commonwealth Edison Co. v. State of Montana, 453 U.S 609, 622, 101 S.Ct. 2946, 2956 (1981).

[5] As provided in T.C.A. § 67-4-811, the three factor apportionment formula multiplies the earnings of the business by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the dominator is three (3):

$$\text{Earnings} \times \frac{\text{property (in state)} + \text{payroll (in state)} + \text{sales (in state)}}{3}$$

JCPNB asserts that if it were to apply this formula, its earnings would be taxed by an average .7%. When comparing this number to the 2% taxed using the single-factor formula, JCPNB arrives at a 300% difference in the income taxed by Tennessee.

approximately 2% of JCPNB's total earnings. The percentage of JCPNB's customers in Tennessee is approximately 2% of its customers nationwide.[6] It does not follow that the single factor formula creates a "gross distortion" or an unfair apportionment merely because applying a different formula would yield a more favorable tax outcome for JCPNB. JCPNB has failed to show by clear and cogent evidence that Tennessee's franchise and excise tax "operates to reach profits which are in no just sense attributable to transactions within its jurisdiction." *Hans Rees'*, 283 U.S. at 133, 51 S.Ct. at 389.

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[6] The following chart lists JCPNB's Tennessee accounts and the taxes assessed using a single receipts formula for the following tax years:

Year	Total Accounts	Tennessee Billing Addresses	% of Tennessee Customers	% of JCPNB Income Taxed by Tennessee
1990	562,638	11,535	2.1	2.0237
1991	541,786	11,247	2.1	2.0954
1992	688,552	14,059	2.0	2.1266
1993	844,348	17,725	2.1	2.1243

CONCLUSION

For the foregoing reasons, the taxes assessed by the Commissioner of Revenue pursuant to T.C.A. §§ 67-4-804 (7), 67-4-806 and 67-4-903 are affirmed.

The Complaint is dismissed, with costs taxed to Plaintiff, JCPNB.

It is so ORDERED.

/s/ Ernest Pellegrin
ERNEST PELLEGRIN
SPECIAL CHANCELLOR

cc: James C. Gooch
Michael D. Sontag
Joe C. Peel

IN THE CHANCERY COURT OF DAVIDSON COUNTY TENNESSEE TWENTIETH JUDICIAL DISTRICT PART I, AT NASHVILLE

JC PENNEY NATIONAL BANK,	)	
Plaintiff,	)	
v.	)	**No. 96-276-I**
RUTH E. JOHNSON, Commissioner of Revenue, State of Tennessee,	)	
Defendant.	)	

FINAL ORDER

(Filed Dec. 7, 1998)

On October 16, 1998, this Court entered its Memorandum and Order in the above-styled case. In that Order, the Court determined the tax assessment made by the Commissioner of Revenue to be proper and dismissed the plaintiff's Complaint. That Memorandum and Order is incorporated herein by reference. Thereby the Court disposed of all the issues in this case except the defendant's prayer for a judgment and claim for attorneys' fees and expenses of litigation as prevailing party under T.C.A. § 67-1-1803(d).

The Court now finds that the defendant Commissioner of Revenue is the prevailing party in this cause within the meaning of T.C.A. § 67-1-1803(d) and is entitled to an award of her reasonable attorneys' fees and expenses of litigation as provided by statute. The Court

finds, however, that determination of the amount of such fees and expenses to which the defendant is entitled should await the outcome of any possible appeals in this cause.

Having determined all of the claims of the plaintiff in this matter, the Court finds there is no just reason for delay in entering a final, appealable judgment as to those claims. The Court, pursuant to T.R.C.P. 54.02, therefore expressly directs that a final, appealable judgment is hereby entered upholding the defendant's tax assessment, granting the Commissioner judgment for the amounts in dispute, and dismissing the Complaint with prejudice. Accordingly, a judgment is hereby entered in favor of the Commissioner of Revenue and against the plaintiff for the assessed amount of $178,314 in taxes, penalty, and interest, plus interest continuing to accrue at the rate specified in accordance with T.C.A. §67-1-801 until the date of payment by the plaintiff, for which execution may issue if necessary.

The Court reserves determination of the amount of attorneys' fees and expenses of litigation to be awarded pursuant to T.C.A. § 67-1-1803(d) in this case until all appeals are concluded. The time within which any notice of appeal may be filed in this cause shall run from the date of entry of this Final Order in accordance with T.R.C.P. 54.02. Within sixty days after that date the prevailing party shall file her application for an award of fees and expenses, unless a timely notice of appeal is filed. If the decision of this Court is appealed, the prevailing party shall file an application for an award of fees and expenses within sixty days after the conclusion of all proceedings in the appellate courts.

All costs of this cause, as previously decreed, are taxed against the plaintiff.

It is so **ORDERED, ADJUDGED,** and **DECREED.**

/s/ Ernest Pellegrin
ERNEST PELLEGRIN
SPECIAL CHANCELLOR

Approved for Entry:

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CONSTITUTIONAL PROVISIONS:

U.S. Const. art. I, §8, cl.3

> **§8. Powers of Congress.** – [1.] The congress shall have power . . .
>
> [3.] To regulate commerce with foreign nations, and among the several states, and with the Indian tribes . . . .

U.S. Const. art. VI, ¶2

> [2.] This Constitution, and the laws of the United States which shall be made in pursuance thereof; and all treaties made, or which shall be made, under the authority of the United States, shall be the supreme law of the land; and the judges in every state shall be bound thereby, any thing in the Constitution or laws of any state to the contrary notwithstanding.

U.S. Const. amend. XIV, §1

> **§ 1. Citizenship – Due process of law – Equal protection.** – All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the state wherein they reside. No state shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any state deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.

STATUTES:
Federal:

28 U.S.C. §1257

§1257. State courts; certiorari

(a) Final judgments or decrees rendered by the highest court of a State in which a decision could be had, may be reviewed by the Supreme Court by writ of certiorari where the validity of a treaty or statute of the United States is drawn in question or where the validity of a statute of any State is drawn in question on the ground of its being repugnant to the Constitution, treaties, or laws of the United States, or where any title, right, privilege, or immunity is specially set up or claimed under the Constitution or the treaties or statutes of, or any commission held or authority exercised under, the United States.

(b) For the purposes of this section, the term "highest court of a State" includes the District of Columbia Court of Appeals.

State:

Tenn. Code Ann. §67-4-801. Short title. – This part may be cited and referred to as the "Excise Tax Law."

Tenn. Code Ann. §67-4-804. Miscellaneous definitions – Legislative intent. – (a) DEFINITIONS. As used in parts 8 and 9 of this chapter, unless the context otherwise requires:

(1) "Business earnings" means earnings arising from transactions and activity in the regular course of the taxpayer's trade or business or earnings from tangible and intangible property if the acquisition, use, management or disposition of the property constitutes an integral part of the taxpayer's regular trade or business operations. In essence, earnings which arise from the conduct of the trade or trades or business operations of a taxpayer are "business earnings," and the taxpayer must show by clear and cogent evidence that particular earnings are classifiable as nonbusiness earnings. A taxpayer may have more than one (1) regular trade or business in determining whether income is "business earnings";

(2)(A) "Business of a financial institution" means:

(i) The business that a regulated financial corporation may be authorized to do under state or federal law or the business that its subsidiary is authorized to do by the proper regulatory authorities;

(ii) The business that any corporation organized under the authority of the United States or organized under the laws of any other taxing jurisdiction or country does or has authority to do which is substantially similar to the business which a corporation may be created to do under title 45, or any business which a corporation or its subsidiary is authorized to do by title 45;

(iii) Otherwise making, acquiring, selling or servicing loans or extensions of credit including, but not limited to, the following:

(*a*) Secured or unsecured consumer loans;
(*b*) Installment loans;
(*c*) Mortgage or deeds of trust or other secured

loans on real or tangible personal property;
(*d*) Credit card loans;
(*e*) Secured or unsecured commercial loans of any type;
(*f*) Letters of credit and acceptance of drafts;
(*g*) Loans arising in factoring; and
(*h*) Any other transactions of a comparable economic effect;
(iv) Leasing or acting as an agent, broker or adviser in connection with leasing real and personal property that is the economic equivalent of an extension of credit; or
(v) Operating a credit card business.
(B) Notwithstanding the provisions of this subdivision (a)(2), if the business of a financial institution generates less than fifty percent (50%) of a corporation's gross income, the corporation shall not be considered to be a financial institution under subdivision (7). For purposes of this subdivision (a)(2)(B), the computation of gross income of a corporation does not include income from nonrecurring, extraordinary transactions;

(3) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed;

(4) "Commissioner" means the commissioner of revenue;

(5) "Compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services;

(6) "Department" means the department of revenue;

(7) "Financial institution" means a holding company, any regulated financial corporation, a subsidiary of a holding company or regulated financial corporation, or any other corporation organized under the laws of the United States or any other taxing jurisdiction that is carrying on the business of a financial institution. However, "financial institution" does not include insurance companies subject to tax under §§ 56-4-201 – 56-4-214;

(8) "Holding company" means any corporation registered under the Federal Bank Holding Company Act of 1956, as amended, or registered as a savings and loan holding company under 12 U.S.C. §1730a.(a)(1)(F), as amended;

(9) "Internal revenue code" means title 26 of the United States Code as effective during the year in which net earnings are determined under this chapter;

(10) "Nonbusiness earnings" means all earnings other than business earnings;

(11) "Regulated financial corporation" means an institution, the deposits, shares, or accounts of which are insured under the Federal Deposit Insurance Act, by the federal savings and loan insurance corporation, or any institution which is a member of a federal home loan bank, any other bank or thrift institution incorporated or organized under the laws of any taxing jurisdiction, or any foreign country which is engaged in the business of receiving deposits, any corporation organized under the provisions of 12 U.S.C. §§ 611-631 (Edge Act corporations), and any agency of a foreign depository as defined in 12 U.S.C. §3101;

(12) "Sales" means all gross receipts of the taxpayer not allocated under this chapter;

(13) "Securities" means United States treasury securities, obligations of United States government agencies and corporations, obligations of state and political subdivisions, corporate stock and other securities, participations in securities backed by mortgages held by the United States or state government agencies, loan-backed securities and similar investments;

(14) "State" means any state of the United States, the District of Columbia, the commonwealth of Puerto Rico, any territory or possession of the United States and any foreign country or political subdivision thereof;

(15) "Taxing jurisdiction" means a state of the United States, the District of Columbia, the Commonwealth of Puerto Rico or a territory or possession of the United States; and

(16) "Unitary business" means business activities or operations of financial institutions that are of mutual benefit, dependent upon, or contributory to one another, individually or as a group, in transacting the business of a financial institution. "Unitary business" may be applied within a single legal entity or between multiple entities. "Unitary group" includes those entities that are engaged in a unitary business wholly within or within and without this state;

(A) Unity is presumed whenever there is unity of ownership, operation and use evidenced by centralized management or executive force, centralized purchasing, advertising, accounting or other controlled interaction among entities that are engaged in

the business of a financial institution. The absence of these centralized activities does not, however, necessarily evidence a nonunitary business;

(B) Unity of ownership does not exist unless the corporation is a member of two (2) or more business entities and more than fifty percent (50%) of the voting stock of each member is directly or indirectly owned by:

(i) A common owner or common owners, either corporate or noncorporate; or

(ii) One (1) or more of the members of the group.

(b) LEGISLATIVE INTENT. It is the intent of the general assembly to tax entities which are subject to the Tennessee franchise excise tax to the extent permitted under the state's constitutional power to tax. The foregoing provisions implement and clarify the distinctions between business and nonbusiness earnings, as found in the Uniform Division of Income for Tax Purposes Act, as generally interpreted by states adopting the act.

Tenn. Code Ann. § 67-4-805. "Net earnings" defined. – (a)(1) Except as provided in subdivision (a)(2) or (3), "net earnings" is defined as federal taxable income before the operating loss deduction and special deductions provided for in 26 U.S.C. §§ 241-247 and 249-250, and subject to the adjustments in subsection (b).

(2) For a corporation electing S corporation status under 26 U.S.C. §§ 1361-1363, "net earnings" is defined as federal taxable income calculated as if the corporation

had not elected S status, taken before the operating loss deduction and special deductions provided for in 26 U.S.C. §§ 241-247 and 249-250, and subject to the adjustments in subsection (b).

(3) For a unitary business, as defined in §67-4-804(a)(13), "net earnings" is defined as the combined net earnings as defined in subdivision (a)(1) for all members of the unitary group with dividends, distributions and receipts from transactions between members of the unitary group excluded, and subject to the adjustments in subsection (b) on a combined basis.

(b)(1) There shall be added to the federal taxable income:

(A) Excise tax imposed by this state to the extent deducted in determining federal taxable income;

(B) Interest income from obligations defined in 26 U.S.C. §103(a), reduced by allowable amortization including any interest expense disallowed for federal purposes pursuant to 26 U.S.C. §§ 265 and 291;

(C) Any deduction made pursuant to 26 U.S.C. §§ 611-617 to the extent the deduction when added with similar deductions in prior years exceeds the cost of the property;

(D) Gains not recognized pursuant to 26 U.S.C. §337;

(E) The charitable contributions deduction claimed under 26 U.S.C. §170;

(F) Any capital loss carrybacks or carryovers deducted pursuant to 26 U.S.C. §1212(a); and

(G) Any expense or depreciation, permitted as a deduction in computing federal taxable income solely as a result of lease characterizations permitted under §168 of the Economic Recovery Tax Act of 1981, which would not have been permitted in the absence of such act; it being the legislative intent that excise tax revenue not be reduced due to lease characterizations made for the purpose of transferring investment tax credits and depreciation allowances from one business entity to another.

(2) There shall be subtracted from the federal taxable income:

(A) Dividends earned by a parent corporation from a subsidiary corporation where such parent owns eighty percent (80%) or more of the stock of the subsidiary;

(B) Any amount included in federal taxable income but not taxable under the laws of this state;

(C)(i) Any net operating loss incurred for fiscal years ending on or after January 15, 1984, "net operating loss" being defined as the excess of allowable deductions over total income allocable to this state for the year of the loss, and which may be carried over and allowed in succeeding tax years until fully utilized in the next succeeding taxable year or years in which the taxpayer has net income, but in no case for more than fifteen (15) years after the taxable year in which the net operating loss occurs. For fiscal years ending on or after July 15, 1990, in the case of a unitary business, as defined in §67-4-804(a)(13), the net operating loss incurred in the current year shall be determined on a combined basis as specified in subdivision (a)(3) and, for tax years ending prior to July 15, 1990, any net operating loss incurred by a

member of the unitary group which has been apportioned to Tennessee in a year prior to filing a combined return shall be allowed to the unitary group in succeeding tax years until fully utilized, but in no case more than seven (7) years after the taxable year in which the net operating loss occurs;

(ii) There shall be added to the net loss as determined for excise tax purposes, all nonbusiness earnings, all interest, dividends excluded from net earnings pursuant to this section and any other income excluded from net earnings pursuant to this section;

(D) A portion of the gain or loss of the sale or other disposition of property having a higher basis for Tennessee excise tax purposes than federal income tax purposes measured by the difference in the Tennessee basis and the federal basis;

(E) Actual charitable contributions made by the corporation during the fiscal year;

(F) Losses not deducted pursuant to 26 U.S.C. §337;

(G) Any capital losses incurred during the fiscal year and not deductible under 26 U.S.C. §1211(a);

(H) Any expense, other than income taxes, not deducted in determining federal taxable income for which a credit against the federal income tax is allowable;

(I) Any amount included in federal taxable income solely as a result of lease characterizations permitted under §168 of the Economic Recovery Tax Act of 1981, which would not have been permitted in the absence of such act;

(J) Any amount of depreciation or other expense which the taxpayer could have deducted in

computing federal taxable income had it not made the election to enter into a lease transaction permitted under §168 of the Economic Recovery Tax Act of 1981, which would not have been permitted in the absence of such act; and

(K) An amount equal to the difference, if any, between the reserve for bad debts allowed under 26 U.S.C. §§ 585 and 593, as such section existed on December 31, 1986, and such reserve as it may have been modified subsequently.

Tenn. Code Ann. §67-4-806. Tax imposed. – (a) All corporations, cooperatives, joint-stock associations and business trusts, including regulated investment companies and real estate investment trusts, organized for profit under the laws of this state or any other state or country and doing business in Tennessee, including state chartered banks and national banks doing business in Tennessee and including state chartered savings and loan associations and federally chartered savings and loan associations doing business in Tennessee shall, without exception other than as provided herein, pay to the commissioner of revenue, annually, an excise tax, in addition to all other taxes, equal to six percent (6%) of the net earnings for the next preceding fiscal year for business done in this state.

(b) Every such taxable entity organized and existing under and by virtue of the laws of this or any other state, territory or country, or organized and existing without any specific statutory authority, now or hereafter doing

business within this state, without domesticating or qualifying to do business in this state, or while its charter is forfeited, revoked or suspended, shall as a recompense for the protection of its local activities and as compensation for the benefits it receives from doing business in Tennessee, pay the tax imposed by this part.

(c) The tax imposed by this part shall apply to corporations whose business is being conducted by a receivership or trusteeship appointed by any court of competent jurisdiction and shall continue to accrue until such time as the corporation has been actually and legally dissolved or withdrawn from this state.

(d)(1) A financial institution shall be presumed, subject to rebuttal, to be doing business in this state if the sum of its assets and the absolute value of its deposits attributable to sources within this state is five million dollars ($5,000,000) or more.

(2) Additionally, a financial institution shall be deemed to be doing business in this state if the institution:

(A) Maintains an office in this state;

(B) Has an employee, representative or independent contractor conducting business in this state;

(C) Regularly sells products or services of any kind or nature to customers in this state that receive the product or service in this state;

(D) Regularly solicits business from potential customers in this state;

(E) Regularly performs services outside this state which are consumed in this state;

(F) Regularly engages in transactions with customers in this state that involve intangible property, including loans, and result in receipts flowing to the taxpayer from within this state;

(G) Owns or leases property located in this state; or

(H) Regularly solicits and receives deposits from customers in this state.

(e)(1) Notwithstanding any other provision to the contrary, a financial institution is not considered to be conducting the business of a financial institution in this state if the only activity of the financial institution in this state is the ownership of an interest in one (1) or more of the following types of property, including those activities within this state that are reasonably required to evaluate and complete the acquisition or disposition of the property, the servicing of the property or the income from it, the collection of income from the property, or the acquisition or liquidation of collateral relating to the property:

(A) An interest in a real estate mortgage investment conduit, a real estate investment trust, or a regulated investment company as those terms are defined by the Internal Revenue Code of 1986, as amended;

(B) An interest in a loan-backed security representing ownership or participation in a pool of promissory notes or certificates of interest that provide for payments in relation to payments or reasonable projections of payments on the notes or certificates;

(C) An interest in a loan, lease, note or other assets attributed to this state and in which the payment obligations were solicited and entered into by a

person that is independent and not acting on behalf of the owner;

(D) An interest in the right to service or collect income from a loan or other asset from which interest on the loan or other asset is attributed to this state and in which the payment obligations were solicited and entered into by a person that is independent and not acting on behalf of the owner;

(E) An interest in demand deposit clearing accounts, federal funds, certificates of deposit and other similar wholesale banking instruments issued by other financial institutions;

(F) An interest in a security; and

(G) An interest of a financial institution in any intangible, tangible, real or personal property acquired in satisfaction, whether in whole or in part, of any asset embodying a payment obligation which is in default, whether secured or unsecured, if the ownership of the interest would be exempt otherwise as provided in subdivisions (e)(1)(A)-(E).

(2) For the purposes of subdivisions (e)(1)(C) and (D), an "independent person who is not acting on behalf of the owner" is defined as follows:

(A) At the time of the acquisition of the assets, the owner of the asset shall not directly or indirectly own fifteen percent (15%) or more of the outstanding stock or, in the case of a partnership, fifteen percent (15%) or more of the capital or profits interest, of the entity from which the owner originally acquired the asset. In determining indirect ownership, an owner is deemed to own all of the stock, capital interest or profits interest owned by another person if the owner directly owns fifteen percent (15%) or more of the stock, capital interest or profits interest in that other

person. Also, the owner is deemed to own all stock, capital interest and profits interest directly owned by any intermediary parties in the transaction, to the extent a fifteen percent (15%) or more chain of ownership of stock, capital interest or profits interest exists between the owner and any intermediary party;

(B) The entity from which the owner acquired the asset shall regularly sell, assign or transfer interest in such assets to three (3) or more persons during the full twelve-month period immediately preceding the month of acquisition; and

(C) The entity from which the owner acquired the asset shall not sell, assign or transfer ninety percent (90%) or more of its exempt assets to the owner during the full twelve-month period immediately preceding the month of acquisition.

Tenn. Code Ann. § 67-4-815. Apportionment of earnings by financial institutions. – (a) A financial institution which is not filing a combined return and which has earnings from business activity both within and without this state shall apportion its business earnings by multiplying such earnings by the quotient of the institution's total receipts attributable to the transaction of business in Tennessee, as determined under subsection (d), divided by the institution's total receipts attributable to transacting business in all taxing jurisdictions, as determined under subsection (d).

(b) A unitary group shall have earnings apportioned to Tennessee which consists of the apportioned net

earnings of the members of the unitary group as determined under the provisions of subsection (a).

(c) For purposes of subsection (a), receipts shall include all gross income, including net taxable gain on disposition of assets such as securities and money market transactions, when derived from transactions and activities in the regular course of business.

(d) Receipts, as used above, shall be attributed to Tennessee as follows:

(1) Receipts from the lease or rental of real or tangible personal property shall be attributed to Tennessee if the property is located in Tennessee;

(2)(A) Interest income and other receipts from assets in the nature of loans or installment sales contracts that are primarily secured by or deal with real or tangible personal property shall be attributed to Tennessee if the security or sale property is located in Tennessee. If any part of the sale property or property standing as security for the payment of the debt is located part within and part without the state, only such proportion of the interest income or other receipts shall be attributed to Tennessee as the value of the property within the state bears to the whole property;

(B) "Value" means only that value which the property would command at a fair and voluntary sale. Value shall be determined at the time the loan is made and shall not vary from year to year. In the event additional real or tangible personal property is pledged as security or otherwise covered under a loan or installment sales contract after the time the loan is made, the ratio based on the value of the

property in the state compared to the whole property shall be adjusted;

(3) Interest income and other receipts from consumer loans not secured by real or tangible personal property shall be attributed to Tennessee if the loan is made to a resident of Tennessee, whether at a place of business, by a travelling loan officer, by mail, telephone or other electronic means;

(4) Interest income and other receipts from commercial loans and installment obligations not secured by real or tangible personal property shall be attributed to Tennessee if the proceeds of the loan are to be applied in Tennessee. If it cannot be determined where the funds are to be applied, the receipts are to be attributed to the state in which the business applied for the loan. As used in this subdivision, "applied for" means initial inquiry (including customer assistance in preparing the loan application) or submission of a completed loan application, whichever occurs first. For attribution purposes, "loan" does not include demand deposit clearing accounts, federal funds, certificates of deposit, and other similar wholesale banking instruments issued by other financial institutions;

(5) All receipts and fee income from the issuance of letters of credit, acceptance of drafts, and other devices for assuring or guaranteeing a loan or credit shall be attributed in the same manner as interest income and other receipts from the loan are attributed as set out in either subdivision (d)(2), (3), or (4);

(6) Interest income, merchant discount, and other receipts, including service charges from financial institution credit card and travel and entertainment credit card

receivables and credit card holders. Fees shall be attributed to the state to which the card charges and fees are regularly billed;

(7) Receipts from the sale of an asset, tangible or intangible, shall be attributed in the same manner that the income from the asset would be attributed under this section;

(8) Receipts from the performance of fiduciary and other services shall be attributed in accordance with §67-4-811(i);

(9) Receipts from the issuance of traveler's checks, money orders or United States savings bonds shall be attributed to the state where such items are purchased; and

(10) Receipts from a participating financial institution's portion of participation loans shall be attributed as otherwise provided under this subsection. A participation loan is any loan in which more than one (1) lender is a creditor to a common borrower.

TENN. CODE ANN. § 67-4-901. Short title. – This part may be cited and referred to as the "Franchise Tax Law."

TENN. CODE ANN. § 67-4-903. Corporations subject to tax – Exemptions. – (a) All corporations, cooperatives, joint-stock associations and business trusts, including regulated investment companies and real estate investment trusts, organized for profit under the laws of this state or any other state or country and doing business in Tennessee, including state chartered banks and national banks doing business in Tennessee shall, without exception other than as provided herein, pay to the commissioner of revenue annually a privilege tax in addition to all other taxes, the rate and measure of which are hereinafter set forth. The tax shall be paid for the privilege of engaging in business in corporate form in this state and shall be in addition to all other taxes levied by any other statute.

(b) Every such taxable entity organized and existing under and by virtue of the laws of this or any other state, territory or country, or organized and existing without any specific statutory authority, now or hereafter doing business within this state, without domesticating or qualifying to do business in this state, or while its charter is forfeited, revoked or suspended, shall as a recompense for the protection of its local activities and as compensation for the benefits it receives from doing business in Tennessee, pay the tax imposed by this part.

(c) The tax imposed by this part shall apply to corporations whose business is being conducted by a receivership or trusteeship appointed by any court of competent jurisdiction, and shall continue to accrue until such time as the corporation has been actually and legally dissolved or withdrawn from this state.

(d) There shall be exempt from the payment of the tax levied under this part any corporation organized under the laws of the state of Tennessee, whose sole expressed corporate purpose is for the furthering of industrial development in communities throughout the state, and doing related matters thereto, and whose stockholders receive no income other than interest or dividends on money invested in such corporation for constructing industrial buildings and whose officers receive no compensation.

(e) There shall be exempt from the payment of the tax levied under this part any regulated investment company or investment fund organized as a unit investment trust taxable as a grantor trust under 26 U.S.C. §§ 671-677, provided, that not less than seventy-five percent (75%) of the value of the investments of such regulated investment company or unit investment trust shall be in any combination of bonds of the United States, state of Tennessee, or any county or any municipality or political subdivision of the state, including any agency, board, authority or commission of the state or its subdivisions.

(f)(1) A financial institution shall be presumed, subject to rebuttal, to be doing business in this state if the sum of its assets and the absolute value of its deposits

attributable to sources within this state is five million dollars ($5,000,000) or more.

(2) Additionally, a financial institution shall be deemed to be doing business in this state if the institution:

(A) Maintains an office in this state;

(B) Has an employee, representative or independent contractor conducting business in this state;

(C) Regularly sells products or services of any kind or nature to customers in this state that receive the product in this state;

(D) Regularly solicits business from potential customers in this state;

(E) Regularly performs services outside this state which are consumed in this state;

(F) Regularly engages in transactions with customers in this state that involve intangible property, including loans, and result in receipts flowing to the taxpayer from within this state;

(G) Owns or leases property located in this state; or

(H) Regularly solicits and receives deposits from customers in this state.

(g) Notwithstanding any other provision to the contrary, a financial institution is not considered to be conducting the business of a financial institution in this state if the only activity of the financial institution in this state is the ownership of an interest in one (1) or more of the following types of property, including those activities

within this state that are reasonably required to evaluate and complete the acquisition or disposition of the property, or the servicing of the property, or the income from it, the collection of income from the property, or the acquisition or liquidation of the collateral relating to the property:

(1) An interest in a real estate mortgage investment conduit, a real estate investment trust, or a regulated investment company as those terms are defined by the Internal Revenue Code of 1986, as amended;

(2) An interest in a loan-backed security representing ownership or participation in a pool or promissory notes or certificates of interest that provide for payments in relation to payments or reasonable projections of payments on the notes or certificates.

(3) An interest in a loan, lease, note or other assets attributed to this state and in which the payment obligations were solicited and entered into by a person that is independent and not acting on behalf of the owner;

(4) An interest in the right to service or collect income from a loan or other asset from which interest on the loan or other asset is attributed to this state and in which the payment obligations were solicited and entered into by a person that is independent and not acting on behalf of the owner;

(5) An interest in demand deposit clearing accounts, federal funds, certificates of deposit and other similar wholesale banking instruments issued by other financial institutions;

(6) An interest in a security;

(7) An interest of a financial institution in any intangible, tangible, real or personal property acquired in satisfaction, whether in whole or in part, of any asset embodying a payment obligation which is in default, whether secured or unsecured, if the ownership of the interest would be exempt otherwise as provided in subdivisions (g)(1)-(4);

(8) For the purposes of subdivisions (3) and (4), an "independent person who is not acting on behalf of the owner" is defined as follows:

(A) At the time of the acquisition of the assets, the owner of the asset shall not directly or indirectly own fifteen percent (15%) or more of the outstanding stock or, in the case of a partnership, fifteen percent (15%) or more of the capital or profits interest of the entity from which the owner originally acquired the asset. In determining indirect ownership, an owner is deemed to own all of the stock, capital interest or profits interest owned by another person if the owner directly owns fifteen percent (15%) or more of the stock, capital interest or profits interest in that other person. Also, the owner is deemed to own all stock, capital interest and profits interest directly owned by any intermediary parties in the transaction, to the extent a fifteen percent (15%) or more chain of ownership of stock, capital interest or profits interest exists between the owner and any intermediary party;

(B) The entity from which the owner acquired the asset shall regularly sell, assign or transfer interest in such assets to three (3) or more persons during the full twelve-month

period immediately preceding the month of acquisition; and

(C) The entity from which the owner acquired the asset shall not sell, assign or transfer ninety percent (90%) or more of its exempt assets to the owner during the full twelve-month period immediately preceding the month of acquisition.

TENN. CODE ANN. § 67-4-904. Rate of tax. – (a) The privilege tax hereby imposed shall be a tax of twenty-five cents (25¢) on the one hundred dollars ($100), or major fraction thereof, of the issued and outstanding stock, surplus and undivided profits of each such corporation as shown by the books and records of such corporation at the close of its last fiscal year preceding the making of the sworn report hereinafter required.

(b) For purposes of this section, "issued and outstanding" stock does not include treasury stock.

TENN. CODE ANN. § 67-4-906. Value of tangible property as minimum tax base – Exempt property. – (a)(1) The measure of the tax hereby imposed shall in no case be less than the actual value of the property owned, or property used, in Tennessee.

(2) There shall not be included within the meaning hereof the value of any property while construction of

same is in progress and, in addition thereto, there is no actual utilization of such property by the corporation either in whole or in part.

(3) In cases where part or all of the property is rented, the actual value of property will be deemed to be the book value of all property owned as shown by the books and records of such corporation at the close of its last fiscal year preceding the making of the sworn report hereinafter required (excepting books with respect to investment costs kept pursuant to regulations of the interstate commerce commission), plus the value of the rental property used which shall be determined by multiplying the net annual rental by the following multiplies:

	Multiples
(A) Real Property	8
(B) Machinery and equipment used in manufacturing and processing	3
(C) Furniture, office machinery and equipment	2
(D) Delivery of mobile equipment	1

(4) "Net annual rental" means the gross annual rental paid by the taxpayer, less the gross rental received by the taxpayer for sub-rental.

(5) For the purposes of this section, "used" means only such property as is actually utilized by the corporation in the conduct of its principal business.

(6)(A) For purposes of this section, any system, method, improvement, structure, device or appliance appurtenant thereto, used primarily

for the control, reduction, or elimination of water or air pollution, or used primarily for the disposal, treatment or recycling of hazardous waste and required to meet mandatory requirements of state, federal or local law, shall not be deemed to be property that is actually utilized by the corporation in the conduct of its principal business. Copies of certificates provided for in § 67-5-604 shall be furnished to the commissioner of revenue by the taxpayer with the franchise tax return to verify exemption.

(B) This exemption shall apply only to property, the construction, reconstruction or erection of which is completed by the taxpayer during corporate fiscal years ending on or after July 15, 1981, or which is acquired by the taxpayer during such fiscal years, and the original use of which commences with the taxpayer and commences during such fiscal years.

(7)(A) For purposes of this section, "property" includes a corporate partner's share of any specific partnership property. The value of such partnership property shall be book value (cost less depreciation) as shown on the partnership books.

(B) The provisions of subdivision (a)(7)(A) shall not, however, apply to corporate partners when the specific partnership property is made up of at least eighty percent (80%) real estate (including, but not limited to, apartments, shopping centers, office buildings, hotels, and motels) which is either leased, rented, offered or held for sale, lease or rental to the public in the ordinary course of business.

(C) Notwithstanding the provisions of subdivision (a)(7)(B), the provisions of subdivision (a)(7)(A) shall apply to any partnership property which is occupied by the corporate partner in its trade or business.

(D) The provisions of subdivision (a)(7)(A) shall only apply, however, if the combined annual payroll and book value of the property of the partnership exceeds one million five hundred thousand dollars ($1,500,000).

(b) In the case of property leased from an industrial development corporation, formed pursuant to title 7, chapter 53, part 1, the value may be determined either in accordance with subsection (a) or, at the taxpayer's election, by capitalizing the lease on taxpayer's books and records in accordance with generally accepted accounting principles. The taxpayer may change its election not more than once during the term of the lease.

TENN. CODE ANN. § 67-4-907. Minimum tax. – The minimum tax payable under this part shall be ten dollars ($10.00).

TENN. CODE ANN. § 67-4-919. Apportionment – Financial institutions. – (a) Notwithstanding any other provision of this part, a financial institution which is not filing a combined report and which has business activity both within and without Tennessee and which is paying

tax based on the value of its issued and outstanding stock, surplus and undivided profits shall apportion its tax base to Tennessee by multiplying the tax base by the quotient of the institution's total receipts attributable to the transaction of business in Tennessee, as determined under subsection (d), divided by the institution's total receipts attributable to transacting business in all taxing jurisdictions, as determined under subsection (d).

(b) A unitary group shall have issued and outstanding stock, surplus and undivided profits apportioned to Tennessee based on the apportioned tax base of each of the members of the unitary group as determined under the provisions of subsection (a).

(c) For purposes of subsection (a), "receipts" includes all gross income, including net taxable gain on disposition of assets such as securities and money market transactions, when derived from transactions and activities in the regular course of business.

(d) "Receipts," as used above, shall be attributed to Tennessee as follows:

(1) Receipts from the lease or rental of real or tangible personal property shall be attributed to Tennessee if the property is located in Tennessee;

(2)(A) Interest income and other receipts from assets in the nature of loans or installment sales contracts that are primarily secured by or deal with real or tangible personal property shall be attributed to Tennessee if the security or sale property is located in Tennessee. If any part of the sale property or property standing as security for the payment of the debt is located part within and part without the state, only such

proportion of the interest income or the receipts shall be attributed to Tennessee as the value of the property within the state bears to the whole property;

(B) "Value" means only that value which the property would command at a fair and voluntary sale. Value shall be determined at the time the loan is made and shall not vary from year to year. In the event additional real or tangible personal property is pledged as security or otherwise covered under a loan or installment sales contract after the time the loan is made, the ratio based on the value of the property in the state compared to the whole property shall be adjusted;

(3) Interest income and other receipts from consumer loans not secured by real or tangible personal property shall be attributed to Tennessee if the loan is made to a resident of Tennessee, whether at a place of business, by a traveling loan officer, by mail, by telephone or by other electronic means;

(4) Interest income and other receipts from commercial loans and installment obligations not secured by real or tangible personal property shall be attributed to Tennessee if the proceeds of the loan are to be applied in Tennessee. If it cannot be determined where the funds are to be applied, the receipts are to be attributed to the state in which the business applied for the loan. As used in this subdivision, "applied for" means initial inquiry (including customer assistance in preparing the loan application) or submission of a completed loan application, whichever occurs first. For attribution purposes, "loan" does not

include demand deposit accounts, federal funds, certificates of deposit, and other similar wholesale banking instruments issued by other financial institutions;

(5) All receipts and fee income from the issuance of letters of credit, acceptance of drafts, and other devices for assuring or guaranteeing a loan or credit shall be attributed in the same manner as interest income and other receipts from the loan are attributed as set out in either subdivision (d)(2), (3) or (4);

(6) Interest income, merchant discount and other receipts, including service charges from financial institution credit card and travel and entertainment credit card receivables and credit card holders. Fees shall be attributed to the state to which the card charges and fees are regularly billed;

(7) Receipts from the sale of an asset, tangible or intangible, shall be attributed in the same manner that the income from the asset would be attributed under this section;

(8) Receipts from the performance of fiduciary and other services shall be attributed in accordance with § 67-4-910(i);

(9) Receipts from the issuance of traveler's checks, money orders or United States savings bonds shall be attributed to the state where such items are purchased; and

(10) Receipts from a participating financial institution's portion of participation loans shall be attributed as

otherwise provided under this subsection. A participation loan is any loan in which more than one (1) lender is a creditor to a common borrower.

TENN. CODE ANN. § 67-6-501. Tax collected from dealer. – (a) Every dealer making sales, whether within or outside the state, of tangible personal property, for distribution, storage, use, or other consumption in this state, or furnishing any of the things or services taxable under this chapter, is liable for the tax imposed by this chapter.

(b) The tax shall be collected from the dealer as defined herein and paid at the time and in the manner as hereinafter provided.

(c) The aforementioned tax at the rate provided by law of the retail sales price, as of the moment of sale, or of the cost price, as of the moment of purchase, as the case may be, shall be collectible from all persons, as defined in § 67-6-102, engaged as dealers, as defined in § 67-6-102, in the sale at retail, the use, the consumption, the distribution, and the storage for use or consumption in this state, of tangible personal property, or in the furnishing of any of the things or services taxable under this chapter.

TENN. CODE ANN. § 67-6-502. Tax paid by consumer. – The tax imposed by this chapter shall be collected by the retailer from the consumer insofar as it can be done.

TENN. CODE ANN. § 67-6-503. Retailer to display price and tax separately. – The commissioner may by regulation provide that the amount collected by the retailer from the consumer in reimbursement of the tax be displayed separately from the list price, the price advertised in the premises, the marked price, or other price on the sale check or other proof of sale.

IN THE CHANCERY COURT FOR DAVISON COUNTY, TENNESSEE, AT NASHVILLE

J.C. PENNEY NATIONAL BANK, Plaintiff,	)	
v.	)	No. 96-276-I
RUTH E. JOHNSON COMMISSIONER OF REVENUE STATE OF TENNESSEE, Defendant.	)	

STIPULATION OF FACTS

(Filed 2-9-98)

1. The J.C. Penney National Bank ("JCPNB") is a National Banking Association.

2. JCPNB's commercial domicile and principal place of business is located in Harrington, Delaware.

3. JCPNB has no offices, branches or other places of business in Tennessee.

4. JCPNB has no directors, officers, or employees located in Tennessee.

5. JCPNB issues credit cards – both Visa and MasterCard.

6. JCPNB has never paid any excise taxes to the State of Tennessee Department of Revenue.

7. JCPNB has never filed an excise tax return with the State of Tennessee Department of Revenue.

8. Some merchants located in Tennessee contracted with banks located in Tennessee which are members of Visa USA or MasterCard International, and in such contracts the merchants agreed to accept at their local stores the Visa or MasterCard credit card for purchases of goods or services and the merchant bank agreed to accept from each merchant the charge slips from Visa and MasterCard credit card transactions for deposit to the merchant's bank account.

9. Other merchants with store locations in Tennessee that accept the Visa or MasterCard credit card have entered into national contracts ("merchant banking agreements") which cover all locations of such a merchant throughout the United States including Tennessee and said merchant banking agreements covering all locations of each merchant on a nationwide – basis may be signed with merchant banks located either inside Tennessee or outside of Tennessee.

10. JCPNB serves as a merchant bank for some merchants with store locations throughout the United States including Tennessee and under these agreements, each merchant has agreed to accept the Visa or MasterCard credit card for purchases of goods and services and JCPNB has agreed to accept the charge slips from Visa and MasterCard credit card transactions for deposit to the merchant's account.

11. These merchants contracting with JCPNB are referred to as "National Accounts" or "National Account Merchants". When JCPNB solicits as merchant bank for a National Account Merchant, it has solicited agreements with the merchant's corporate headquarters rather than

directly with the local outlets of the merchant. All payments between the National Accounts Merchants and JCPNB were made to the National Account Merchant's corporate headquarters rather than the National Account Merchant's local outlets. None of JCPNB's National Account Merchants had their corporate headquarters in Tennessee.

12. Local credit bureaus in Tennessee are operated as for-profit corporations or as non-profit corporations formed by local merchants for the purpose of assembling necessary credit information for the merchants to engage in credit transactions. Local merchants who are members of a credit bureau will, on a regular basis, provide their credit files to the credit bureau to which they are a member to be assembled for credit reporting purposes. Merchants with large numbers of accounts submit this information by computer tapes to their local credit bureau on a regular basis. The local bureau is usually an affiliate of one of the three national automated consumer reporting agencies (Transunion, TRW and Equifax). The local credit bureau forwards the local creditors' regularly submitted account information to its national consumer reporting affiliate. The national consumer reporting agency incorporates this credit information into its existing credit files. The local credit bureau uses the automated credit files of its national credit reporting service to provide credit reports to its subscribers. When JCPNB contracted with national credit reporting agencies, it did

so through contracts negotiated with the national credit reporting agencies' offices outside of Tennessee.

Respectfully submitted,

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Supreme Court, U.S.
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SEP - 7 2000
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(2)

No. 00-205

IN THE

Supreme Court of the United States

RUTH E. JOHNSON, COMMISSIONER OF REVENUE, STATE OF TENNESSEE,

Petitioner,

v.

J.C. PENNEY NATIONAL BANK,

Respondent.

On Petition for Writ of Certiorari to the Court of Appeals of Tennessee

RESPONDENT'S BRIEF IN OPPOSITION

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QUESTION PRESENTED

May a State, contrary to this Court's definition of the "substantial nexus" requirement of the Commerce Clause in *National Bellas Hess, Inc. v. Department of Revenue* and *Quill Corporation v. North Dakota*, impose franchise and excise (net income) taxes on corporations that have established no direct or indirect physical presence in the taxing jurisdiction?

CORPORATE DISCLOSURE STATEMENT

Respondent J.C. Penney National Bank was a federally chartered national banking association incorporated under the laws of Delaware; it was dissolved on December 17, 1998. Prior to its dissolution, Respondent was a wholly owned subsidiary of J.C. Penney Company Inc., a publicly-held corporation. J.C. Penney Company will be responsible for paying the Petitioner's tax assessment if it is ultimately held to be valid. No parent or publicly held company owns 10% or more of J.C. Penney Company's stock.

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RESPONDENT'S BRIEF IN OPPOSITION

Respondent J.C. Penney National Bank ("JCPNB") requests that this Court deny the petition ("Pet.") for writ of certiorari filed by Ruth E. Johnson, Commissioner of Revenue, State of Tennessee (the "Commissioner"), seeking review of the decision of the Tennessee Court of Appeals entered in this case on December 17, 1999.

STATEMENT

In her petition, the Commissioner asks this Court to reconsider and overturn the bright-line standard that, for over thirty-five years, has marked the outer limit of a state's power to tax interstate commerce. In the decision below, Tennessee's intermediate appellate court applied well-established Commerce Clause principles, as most recently explained in *Quill Corp. v. Commissioner*, 504 U.S. 298 (1992), and held unconstitutional a tax levied against an out-of-state taxpayer that had no substantial nexus with Tennessee. The opinion is a well-reasoned, unexceptional application of this Court's precedents.

This Court repeatedly has held that states may constitutionally tax only those out-of-state businesses that have a "substantial nexus" with the state. An attempt to impose *any* tax upon an out-of-state business that lacks this "substantial nexus" unduly burdens interstate commerce in violation of the Commerce Clause. *See, e.g., Complete Auto Transit v. Brady*, 430 U.S. 274 (1977); *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 626 (1981); *Fulton Corp. v. Faulkner*, 516 U.S. 325, 334 (1996). This Court has twice expressly held that, to establish substantial nexus, an out-of-state business must have a physical presence in the taxing state. *National Bellas Hess, Inc. v. Department of Rev. of Illinois*, 386 U.S. 753 (1967); *Quill*, 504 U.S. at 298. While *Bellas Hess* and *Quill* both involved state sales and use taxes, *every* state tax that has withstood this Court's Commerce Clause scrutiny has involved

a taxpayer with a meaningful physical presence within the taxing state.

In her petition, the Commissioner characterizes the decision below as an aberration in the development of "contemporary commerce clause jurisprudence" (Pet. 13), and asks this Court to "reject such an unwarranted application of its precedents." (Pet. 11) Contrary to these claims, however, the decision below is an unremarkable application of the "substantial nexus" standard developed and applied by this Court in *Quill*, *Complete Auto*, and many other cases. Indeed, the court below noted that the Commissioner was "unable to provide any authority" supporting a departure from this Court's well-settled definition of "substantial nexus." (Pet. App. 18a-19a) Applying this Court's precedents, the court below held that Tennessee could not tax JCPNB solely because the bank had availed itself of economic markets in Tennessee exclusively through use of the U.S. mail. (Pet. App. 29a)

STATEMENT OF THE CASE

1. JCPNB'S Business In Tennessee.

In 1983, J.C. Penney Company acquired the Harrington National Bank and changed its name to J.C. Penney National Bank. (Pet. App. 3a & n.1) JCPNB was a federally chartered national banking association, was incorporated under the laws of Delaware, and was separately incorporated from the J.C. Penney Company. JCPNB's principal place of business and commercial domicile was Harrington, Delaware. (Pet. App. 3a-4a & n.2) JCPNB engaged primarily in credit card lending and consumer banking by issuing VISA and MasterCard credit cards and by offering banking services such as commercial and consumer loans and savings and checking accounts.[1] (Pet.

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[1] JCPNB's lending activities were limited to issuing "universal cards" such as VISA and MasterCard, which are accepted at world-wide business locations. These credit cards are separate from the J.C.

App. 3a-4a) JCPNB ceased its banking operations on December 17, 1997, sold all of its consumer banking and credit card business in a variety of transactions over the course of the following year, and dissolved on December 17, 1998.

Throughout its existence, JCPNB conducted all of its business activities from its Delaware offices; "[n]one of the[se] activities . . . occurred in the State of Tennessee." (Pet. App. 6a) JCPNB had "no offices or other places of business in Tennessee" and did not own or lease any tangible or intangible property in Tennessee. (*Id.*) A majority of the bank's directors, and all of its officers and employees, were located in Delaware. (*Id.*)

JCPNB "outsourced" much of the work associated with its credit-card business to other entities. In some cases, these entities were related to JCPNB (such as the J.C. Penney Company and Business Services, Inc.); in other cases they were not (such as MBNA and SSBA).[2] But in all cases, these entities operated entirely outside of Tennessee. (Pet. App. 4a-6a) The J.C. Penney Company retail stores in Tennessee performed no credit-card solicitation or processing services for or on behalf of JCPNB. In fact, consumers could neither apply for, nor make payment on, JCPNB's credit cards at the retail stores because either activity would have violated federal law. (Pet. App. 6a & n.6, 22a-23a)

Penney Company proprietary card, which is accepted exclusively at J.C. Penney Company retail stores. JCPNB had no role in J.C. Penney Company's proprietary card activities. Similarly, J.C. Penney Company's retail stores had no role in JCPNB's universal card activities. (Pet. App. 4a & n.2; *id.* at 6a)

[2] These related-party contracts were negotiated and performed at arm's length, as required by federal banking law. Pet. App. 5a n.3; *see also* Federal Reserve Act § 238, 12 U.S.C. § 371e-1.

2. Tennessee's Franchise and Excise Tax.

Tennessee imposes a franchise and excise tax on financial institutions "doing business" in Tennessee. Tenn. Code Ann. §§ 67-4-806, 67-4-903. A financial institution is deemed to be "doing business" in Tennessee if it "regularly solicits business from potential customers" in Tennessee or "regularly engages in transactions with customers in [Tennessee] that involve intangible property, including loans, and result in receipts flowing to the taxpayer from within [Tennessee]." Tenn. Code Ann. §§ 67-4-806(d)(2), 67-4-903(f)(2). Tennessee enacted this financial institutions tax in 1990, seeking for the first time to tax out-of-state financial institutions that had no physical presence in the state, but that solicited business from Tennessee consumers through the U.S. mail. The Tennessee legislature simultaneously sought to tax the mail-order sales industry by passing an amendment purporting to subject out-of-state vendors who "regularly solicit" Tennessee consumers to state use taxes, even though mail-order companies had no physical presence in Tennessee and even though this Court had held in *National Bellas Hess, Inc. v. Department of Revenue of Illinois*, 386 U.S. 753 (1967), that states could not extend the reach of their taxing powers so far. In *Bloomingdale's By Mail Ltd. v. Huddleston*, 848 S.W.2d 52 (Tenn. 1993), the Tennessee Supreme Court, consistent with this Court's *Quill* decision, held that the legislature had over-stepped its taxing authority.

JCPNB never filed an excise or franchise tax return with the Tennessee Department of Revenue (the "Department"), nor did it ever pay excise taxes to Tennessee. In fact, JCPNB never paid an excise or income tax to any state other than Delaware, and JCPNB's Delaware income tax liability was based upon 100% of its net income. (Pet. App. 8a)

The Department audited JCPNB for the period of February 1990 through January 1994. On November 1, 1995, the Department issued a $178,314 assessment to JCPNB,

which included $111,725 in franchise and excise taxes, $27,932 in penalties, and $38,657 in interest. The Department calculated the assessment by applying a single-factor, gross receipts apportionment formula applicable to financial institutions. Tenn. Code Ann. §§ 67-4-815, 67-4-919; Pet. App. 8a.[3]

3. The Proceedings Below.

In the trial court, the Chancellor concluded that JCPNB had established a "meaningful physical presence" in Tennessee, and thus had "substantial nexus," chiefly because some JCPNB-issued VISA and MasterCard credit cards were present in Tennessee, and because JCPNB's parent, the J.C. Penney Company, operated retail stores in Tennessee. (Pet. App. 40a-42a)

Tennessee's intermediate appellate court reversed. It concluded that this Court's physical-presence standard for "substantial nexus" could not be satisfied by the presence of the credit cards in Tennessee, because "the real asset is the intangible account which the card represents" and which was "located, for tax purposes, in the State of Delaware." (Pet. App. 22a) The court also rejected the Chancellor's holding that a substantial nexus existed based on "the activities of the

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[3] The standard apportionment formula applicable to out-of-state corporations doing business in Tennessee is a three-factor formula that compares the out-of-state corporation's property, payroll, and sales located or occurring in Tennessee to the out-of-state corporation's property, payroll, and sales located or occurring elsewhere. Tenn. Code Ann. §§ 67-4-811, 67-4-910. By contrast, financial institutions such as JCPNB are subject to a single-factor apportionment formula based exclusively on a comparison of the financial institution's gross receipts attributable to business activities conducted in Tennessee and the gross receipts attributable to all of its business activities conducted everywhere. Tenn. Code Ann. §§ 67-4-815, 67-4-919.

affiliates and third parties working on JCPNB's behalf" (Pet. App. 23a) because the activities on which the Chancellor had relied occurred entirely outside of Tennessee (Pet. App. 22a-23a). Furthermore, the court held that the J.C. Penney Company's Tennessee retail stores could not create a substantial nexus between JCPNB and Tennessee because the stores were unrelated to any aspect of JCPNB's business. (*Id.*) Instead, it held that an out-of-state bank that conducted a credit-card business with Tennessee cardholders exclusively through the U.S. mail lacked the "substantial nexus" that the Commerce Clause requires for a state to assert its taxing authority. (Pet. App. 26a) Accordingly, just as the Tennessee Supreme Court struck down Tennessee's unconstitutional mail-order tax in *Bloomingdale's By Mail*, the court below struck down this related attempt to tax out-of-state banks connected to Tennessee only by consumer solicitations through the U.S. mail.

The Tennessee Supreme Court declined the Commissioner's application for discretionary review without comment. (Pet. App. 29a)

REASONS FOR DENYING THE WRIT

I. THE TENNESSEE COURT OF APPEALS' DECISION WAS A ROUTINE APPLICATION OF THIS COURT'S PRECEDENTS THAT DOES NOT CONFLICT WITH ANY DECISION OF THIS COURT OR OF A STATE COURT OF LAST RESORT

This is not an appropriate case for certiorari. The question before the Tennessee Court of Appeals was whether the Commerce Clause permits Tennessee to impose its franchise and excise tax on an out-of-state financial institution that conducted business with Tennessee residents exclusively through the U.S. mail and that had established no direct or indirect physical presence in Tennessee. The opinion below properly

considered and applied this Court's precedents to find that JCPNB had not established the "substantial nexus" required by the Commerce Clause and, thus, that Tennessee could not tax JCPNB. Accordingly, Petitioner presents no issue that warrants this Court's plenary review.

A. The Decision Below Was Factbound And Did Not Explicitly Apply a "Physical Presence" Rule

Tennessee's intermediate appellate court did not even decide the issue that the Commissioner has presented to this Court. A careful reading of the decision below indicates that the court did not explicitly adopt a "physical presence" test to determine whether Tennessee may impose franchise and excise taxes on an out-of-state business. The court below recognized that "[t]he analysis in this area is necessarily done on a case-by-case basis" and that "[t]here is no . . . specific point at which a substantial nexus exists." (Pet. App. 18a) Furthermore, it expressly disclaimed deciding whether "physical presence" was required, noting that "[it] is not our purpose to decide whether 'physical presence' is required under the Commerce Clause." (Pet. App. 25a) Instead, the court employed this Court's precedents—including, but by no means limited to, *Quill* and *Bellas Hess*—as guideposts to "delineate that level of 'presence' in the State of Tennessee that will justify the imposition of the types of taxes that are the subject of this appeal." (Pet. App. 18a) After considering all of the facts and circumstances in the record, the court concluded that JCPNB did not have a sufficient presence in—"nexus" to—Tennessee to be subjected to the franchise and excise tax.

Contrary to the Commissioner's assertion (Pet. 20), the court below did not, in making its factbound analysis, "unwittingly extend" *Quill's* physical-presence test to the franchise and excise taxes before it. The court merely considered and rejected (Pet. App. 11a-12a, 17a-18a) the Commissioner's attempt to create a novel constitutional test for substantial nexus that not only would have eliminated any

physical-presence requirement, but that also would have replaced the Court's "substantial nexus" Commerce Clause jurisprudence with the "purposeful availment" standard that defines Due Process Clause "minimum contacts," *see Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 475 (1985). The Commissioner urged below, and argues anew here, that Tennessee should have the power to tax businesses that "purposefully avail themselves of the market within [Tennessee]" or that otherwise have "established continuing business relationships with customers in [Tennessee] through interstate commerce." (Pet. 27-28) As the court below noted, this test would "obliterate" (Pet. App. 18a) the "fundamental[ ]" line that *Quill* drew between Due Process "minimum contacts" and Commerce Clause "substantial nexus" (504 U.S. at 305, 313) and would subject JCPNB to tax in any state in which its account holders traveled and made credit-card purchases.[4]

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[4] Consider the case of a Tennessee resident who purchases a meal from a Chicago restaurant that deposits the credit card slip in its New York merchant bank. In turn, the New York bank submits the credit card slip to the Delaware bank that issued the credit card for payment. Under the Commissioner's test, each of Tennessee, Illinois, New York and Delaware would have the authority to tax the extension of credit—especially if the Delaware bank had other credit-card customers in each of the foregoing states. *See National Geographic Soc'y v. California Bd. of Equalization*, 430 U.S. 551, 558 (1977) (holding that once the taxpayer establishes nexus with the taxing state, all of the taxpayer's activities related to that state are constitutionally taxable). Under the current physical-presence standard, only Delaware could tax the interest income earned by the Delaware bank from the credit card transaction (and, in fact, as noted above, Delaware has imposed such a tax on 100% of JCPNB's income). As Part II below discusses more fully, Congress is best qualified to weigh the myriad of policy issues associated with establishing a cohesive state-tax nexus regime.

Having rejected the Commissioner's attempt to rewrite this Court's precedents, the court below reached its conclusions without expressly adopting a "bright-line" physical-presence standard. Instead, the court held that, regardless of the exact level of "presence" required by the Commerce Clause, it "fail[ed] to see the substantial nexus necessary to sustain the tax." (Pet. App. 26a) Thus, the fact-intensive analysis that yielded the decision below falls well short of deciding the pure legal issue that the Commissioner has presented to this Court for review. Accordingly, this Court should deny the petition.

B. This Court Has Consistently Held That An Out-Of-State Taxpayer Must Have a Substantial Physical Presence Within the Taxing State to Establish a "Substantial Nexus"

Even if the decision below had required physical presence for "substantial nexus," such a holding would be entirely consistent with this Court's Commerce Clause jurisprudence. This Court has twice expressly held that "substantial nexus" requires physical presence, *National Bellas Hess*, 386 U.S. at 753; *Quill*, 504 U.S. at 298, and every case that has upheld nexus to tax has done so only where the taxpayer in fact had a physical presence in the taxing state.

Cases decided by this Court both before and after *Quill* have made clear that a substantial nexus is required for the imposition of *any* state tax on an out-of-state business. *See, e.g., Allied Signal, Inc. v. Director*, 504 U.S. 768, 778 (1992) ("The constitutional question in a case such as *Quill Corp.* is whether the State has the authority to tax the corporation *at all*." (emphasis added)); *Commonwealth Edison Co.*, 453 U.S. at 626 ("Under this threshold test, the interstate business must have a substantial nexus with the State before *any* tax may be levied on it." (emphasis in original)). Indeed, *Quill* itself did not limit the physical-presence requirement to state sales and use taxes; it merely observed that "we have not, in our review of other types of taxes, articulated the same physical-presence

requirement that *Bellas Hess* established for sales and use taxes." 504 U.S. at 314.

The Commissioner has pointed to no Commerce Clause decision of this Court that has found "substantial nexus" in the absence of physical presence; indeed, in discussing the prior decisions of this Court that are alleged to conflict with the decision below, the Commissioner concedes that "there may have been some form of physical presence in these instances." (Pet. 19) We are certainly aware of no case upholding state-taxing nexus in the absence of physical presence, and commentators have opined that no such case exists:

> [In *Quill*], the Court nevertheless made it clear that the nexus required under the Commerce Clause is more than the minimum contacts/purposeful availment of a state's market that are sufficient to satisfy the modern Due Process Clause; and at least to this point, "substantial nexus" sufficient to satisfy the Commerce Clause has *always involved some degree of physical presence* with the state.

Constitutional Limitations on Jurisdiction to Tax and the Impact of Quill and Geoffrey, State Tax Notes, Aug. 7, 1995, at 423 (emphasis added).

Certainly, this Court has never suggested that the meaning of "substantial nexus" varies from one context to another, and it would be strange indeed to do so. This shifting standard would yield the bizarre result that a state could establish substantial nexus with an out-of-state taxpayer for one type of tax but not for another. On the contrary, this Court has not hesitated to apply "substantial nexus" principles derived in cases involving sales and use taxes to cases involving other types of state taxes. *See, e.g., Tyler Pipe Indus., Inc. v. Washington State Dep't of Rev.*, 483 U.S. 232 (1987) (relying on *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960)), which involved a state use tax, to analyze whether a taxpayer had a substantial nexus with a state that subjected it to a direct business tax).

Moreover, this Court has never intimated that *Quill*'s definition of "substantial nexus" applies only to sales and use taxes; indeed, this Court has characterized the constitutional question decided in *Quill* as "whether the state has the authority to tax the corporation *at all*." *Allied Signal*, 504 U.S. at 778 (emphasis added). This treatment is consistent with the Court's steadfast refusal to draw artificial distinctions among various types of state taxes, which could cause their validity to turn on "legal terminology" and "draftsmanship and phraseology." *See Complete Auto Transit*, 430 U.S. at 281.

The Commissioner's position also would yield the bizarre result that the Commerce Clause's substantial-nexus test imposes a rigorous physical-presence standard for a use-tax collection obligation—an obligation which merely imposes administrative burdens on the out-of-state company—but allows direct taxation of an out-of-state bank's net income and net worth (*and* imposes administrative costs on the taxpayer) under a much more relaxed and amorphous standard. Contrary to the Commissioner's submission, however, this Court has expressly refused to distinguish jurisdiction to tax from jurisdiction to compel collection of taxes as agent for the state. *National Geographic Soc'y v. California Bd. of Equalization*, 430 U.S. 551, 558 (1977); *see also Quill*, 504 U.S. at 319 (Scalia, J. concurring) ("As an original matter, it might have been possible to distinguish between jurisdiction to tax and jurisdiction to compel collection of taxes as agent for the State, but we have rejected that.").

Although the court below pointed out that the "Commissioner [was] unable to provide any authority as to why the [substantial nexus] analysis should be different for franchise and excise taxes" (Pet. App. 19a), she attempts in her petition to make the case that direct income taxes are less burden-some than use-tax collection obligations (Pet. 15). Her attempt is far from compelling.

First, she does not account for the direct financial burdens that income taxes place on the taxpayer beyond the associated administrative costs. This Court itself has remarked that these direct burdens and their associated risk of unconstitutional multiple taxation make the case for striking down an income tax imposed upon an out-of-state business even stronger than the case for striking down the imposition of a mere use tax collection obligation. *See National Geographic Soc'y*, 430 U.S. at 557-58; *Standard Pressed Steel Co. v. Washington Rev. Dep't*, 419 U.S. 560 (1975).[5]

Second, notwithstanding her reliance upon the difference in the number of filing jurisdictions for sales and use taxes, and the relative administrative burdens associated with such taxes, the Commissioner developed no record that would support this "burden" argument below—an omission that would severely handicap plenary review—and her submission on this point is dubious in any event.[6]

Finally, the Commissioner has ignored the myriad of other compliance burdens that multistate businesses face when preparing and filing corporate net-worth and income-tax returns

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[5] Indeed, the Tennessee statute imposes precisely that risk of multiple taxation. JCPNB paid an income tax to the state of Delaware based on 100% of its net income, yet Tennessee does not even provide for a credit mechanism by which this multiple taxation burden may be alleviated. Tenn. Code Ann. § 67-4-808; Pet. App. 8a.

[6] The Commissioner ignores the fact that, although there may be filing requirements in 6,000-plus jurisdictions imposing sales and use taxes, the sales and use tax rules are generally uniform among the various filing jurisdictions in a given state. Thus, businesses must contend only with about 50 sets of rules for and exemptions to the use tax—approximately the same number of sets of rules for determining net worth and income taxes owed to the various states. (*See* Pet. at 15)

and paying the taxes shown thereon. The process of filing a state income-tax return is far more complicated and burdensome than simply applying a tax rate to the number shown as federal taxable income on the corporation's federal income-tax return. Indeed, a treatise cited by the Commissioner devotes approximately *800 pages* to the legal principles and compliance issues associated with state corporate income taxes. Hellerstein & Hellerstein, *State Taxation* (3d ed. 1998).[7] For

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[7] The following highlights only some of these numerous compliance issues:

First, there is the threshold issue of identifying the taxpaying unit. Affiliated groups filing consolidated income tax returns for federal purposes must determine, with respect to each state, which of their various member corporations are subject to tax in each state. Not only may the affiliates with direct jurisdictional nexus vary from state to state, but so also may the legal standards for determining both nexus and those group members that are engaged in a unitary business. *See generally* Hellerstein, *supra*, at 8-57 to 8-211. If a corporation is part of a "unitary business" with its affiliates, many states will include its income in the apportionable tax base for the unitary group. The petition may provide the best evidence of the convoluted analysis that every multistate business would have to perform when determining whether the "economic presence" of the business within the state is sufficient to subject it to a state's taxing jurisdiction. Even if the legal issues are clear, tax record keeping by the overall group may be complicated by the varying sets of in-state taxpayers. Moreover, if some affiliates are deemed outside the state's taxing jurisdiction, transactions between the inside and outside affiliates are subject to review under statutory provisions giving the revenue administrator the power to reallocate income among affiliated taxpayers if the administrator determines that the taxpayer is inappropriately shifting income to other states. *See, e.g.*, Tenn. Code Ann. § 67-4-804(c).

Second, once the precise taxpaying unit is identified, taxpayers must then determine the potential tax base that is within each state's

these reasons, if there were to be different standards for "substantial nexus" for different types of taxes, a taxpayer should have a *more* substantial connection to a state to be

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reach. States follow different income apportionment formulas—in some cases, for example, giving extra weight to the sales factor to a variety of degrees. *See generally* Hellerstein, *supra*, at 9-114 to 9-258. For example, New York double weights the sales factor for regular tax (but not for minimum tax) purposes; Illinois, Connecticut, Kentucky, Massachusetts, Ohio and Tennessee, among others, simply double-weight the sales factor; and Minnesota's three-factor formula is weighted 70-15-15 in favor of sales. Some states, including Tennessee, single out financial institutions for special apportionment formulas. *See generally id.* In Tennessee, a single factor sales formula is used for financial institutions. Tenn. Code Ann. § 67-4-815. Even where the formulas are facially the same, their precise meaning may differ from state to state. As an example, the includability, and if includable, the location, of intangible property and the income derived from such property under what appear to be identical formulas vary widely from state to state.

Third, income tax compliance involves applying the rules for determining taxable income once the potential tax base is known. Contrary to the Commissioner's argument, it is in the sales and use tax area where determination of the tax is simply a matter of multiplying gross receipts by the sales tax rate. States' rules for computing taxable income, however, vary from the federal rules and from each other in significant respects. For example, California and New York have their own depreciation systems for business property. All property subject to these systems therefore has a different basis and, as a result, a different amount of gain or loss upon disposition. Tennessee itself has modified federal depletion rules, federal charitable contribution rules, rules with respect to interest earned on certain municipal bonds, federal capital loss and net operating loss carry forwards, certain federal depreciation allowances related to leasing transactions, and federal accounting for bad debt reserves. *See* Tenn. Code Ann. § 67-4-805.

subject to an income tax because there is in that situation a higher potential to burden interstate commerce.

This Court has noted on several occasions that "our law in this area is something of a 'quagmire' and its 'application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the states in the exercise of their indispensable power of taxation." *Quill*, 504 U.S. at 315-16 (citing *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 457-458 (1959)). Indeed, *Quill* concluded that, despite some "artificial[ity] at its edges," the "bright-line [physical presence] rule . . . furthers the ends of the dormant Commerce Clause" by "firmly establish[ing] the boundaries of state authority" to tax and "reduc[ing] litigation concerning those taxes." 504 U.S. at 314-15. The benefits of certainty and predictability in the administration of state taxing statutes, and the resulting reduction in litigation, are at least as worthy of protection in the context of state franchise and excise taxes as in the context of state sales and use taxes. As further noted in *Quill*, this consistency "encourages settled expectations, and in doing so, fosters investment by businesses" such as JCPNB that are confronted with a plethora of state taxing schemes. *Id.* at 316.

By contrast, the Commissioner's "economic presence" test for state income and net worth taxes would result in different

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As further proof of the complexity of state franchise and excise tax issues, one need only compare the Tennessee sales and use tax return, which consists of two pages, with the Tennessee franchise and excise ("F&E") tax return, which consists of ten pages. Furthermore, financial institutions and their unitary affiliates must file a special Tennessee F&E Tax Return that similarly consists of ten pages. *See* Tennessee Dep't of Revenue Franchise and Excise Tax Forms (visited Aug. 31, 2000) <http://www.state.tn.us/revenue/forms/fae/index.htm>.

tests for the same "substantial nexus" standard—one applicable to sales and use taxes, another for state income and net worth taxes. This test would only further confuse this area of the law. The Commissioner's murky "I know nexus when I see it" standard would introduce significant uncertainty—and protracted litigation—into this otherwise well-settled area.

C. No Conflict Exists Among State Courts of Last Resort Regarding a State's Power to Subject an Out-of-State Taxpayer to a State Income Tax

Contrary to the Commissioner's claims, state courts have not, in the wake of *Quill*, "fallen into disarray" (Pet. at 21) concerning the proper standard for evaluating substantial nexus under the Commerce Clause in the context of other state taxes. Only two state courts of last resort—not, importantly, including the decision of Tennessee's intermediate appellate court below—have specifically addressed *Quill*'s application to other types of state taxes. These two decisions, by the Commissioner's own admission (Pet. App. 21a-22a), do not "conflict" with one another, so there is no conflict among state courts of last resort. *See* S. Ct. Rule 10(b). Moreover, the Commissioner's asserted "obviou[s] . . . direct conflict" (Pet. at 22) between those two decisions and the decision below dissolves upon examination.

The Commissioner relies (*id.*) on dicta from *Couchot v. State Lottery Commission*, 659 N.E.2d 1225 (Ohio 1996), in which the Supreme Court of Ohio mused that this Court had affirmatively limited the physical-presence substantial nexus standard to sales and use taxes. However, as the Ohio Supreme Court noted, the peculiar facts in that case *did* demonstrate physical presence: A Kentucky resident purchased a winning Ohio lottery ticket in Ohio. Not surprisingly, the court held that the Ohio lottery winnings were subject to Ohio income taxation: "Couchot played the Ohio lottery. He purchased his winning ticket in Ironton and redeemed it in Columbus. The entire income received by

Couchot . . . is directly related to his physical presence in Ohio." *Id.* at 1230. Thus, the taxpayer's physical presence in Ohio satisfied *Quill*'s standards. *Id.*[8]

In *Geoffrey, Inc. v. South Carolina Tax Commissioner*, 437 S.E.2d 13 (S.C. 1993), the South Carolina Supreme Court summarily concluded, in two brief paragraphs, that "[i]t is well settled that the taxpayer need not have a *tangible*, physical presence in a state for income to be taxable there. The *presence of intangible property* alone is sufficient to establish nexus." *Id.* at 18 (emphases added).[9] The South Carolina court thus relied upon a standard of "intangible" physical presence to force-fit its case within the "substantial nexus" standard of *Quill*; it concluded that the taxpayer had established a presence in South Carolina through its licensees' substantial use of a license and trademark within the state, which gave its property a business situs or "presence" in South Carolina sufficient to establish "substantial nexus." *Id.* at 16-17. But that holding does not conflict with the Tennessee

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[8] The Commissioner's characterization of the Illinois intermediate appellate court decision in *Borden Chemicals and Plastics, L.P. v. Zehnder*, 726 N.E.2d 73 (Ill. App. Ct. 2000), is similarly flawed. *Borden* involved an Illinois operating limited partnership and an out-of-state limited partner. Finding that the operating partnership was an "agent or conduit" through which the out-of-state limited partnership's income passed, the court concluded that the limited partnership had a physical presence in Illinois. *Id.* at 80.

[9] The authority on which the South Carolina Supreme Court relied for these supposedly "well-settled" principles was a dubious line of pre-*Quill* intermediate appellate court cases from New Mexico and this Court's decision in *International Harvester Co. v. Wisconsin Department of Taxation*, 322 U.S. 435 (1944). These pre-*Quill* cases, however, applied the minimal Due Process nexus standard and never considered the higher hurdle imposed by the Commerce Clause in light of the *Quill* principles discussed above.

courts' holdings below: Here, the trial court found that the "situs of JCPNB's intangible property is located in Delaware" (Pet. App. 41a), and the Commissioner did not challenge that finding on appeal. Thus, whatever flaws the *Geoffrey* opinion may have had, its "intangible physical presence" holding presents no conflict with the decision below.

Contrary to the Commissioner's view of this area of the law, the state courts have consistently held that some meaningful physical presence must be established by an out-of-state taxpayer to subject it to a state's taxing jurisdiction for income-based taxes as well as collection obligations. In addition to *Couchot* and *Geoffrey*, see *Cerro Copper Products, Inc. v. State of Alabama*, F. 94-444 (Admin. Law Div. 12/11/95) (Alabama franchise tax); *Magnetek Controls, Inc. v. Department of Treasury*, 562 N.W.2d 219 (1997) (Michigan single business tax); *Guardian Indus. Corp. v. Department of Treasury*, 499 N.W.2d 349 (1993) (same); *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. App. 2000) (Texas franchise tax). Like the court below, none of these courts has distinguished sales and use taxes on the one hand, and other forms of state taxes on the other, in a way that would justify the radically different constitutional "substantial nexus" tests for each proposed by the Commissioner here.[10]

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[10] The Texas Court of Appeals in *Bandag* summed up the issue in words generally appropriate to this case:

> The term "substantial nexus" is a term of art. In the context of sales and use taxes, the Supreme Court has held that the term requires a physical presence in the taxing state when the vendor's only activity within the state is interstate communication with its customers via common carrier and the United State mail. *See Quill Corp.*, 504 U.S. at 311, *National Bellas Hess, Inc. v Department of Revenue*, 386 U.S. 753, 758, 87 S. Ct. 1389, 18 L. Ed. 2d 505 (1967). BLC is not physically present in Texas. The Comptroller argues, however, that *Quill Corp.* and *Bellas*

In sum, there is no conflict, and certainly no "disarray," among the lower courts that warrants certiorari review.

II. THERE IS NO OTHER COMPELLING BASIS FOR THIS COURT'S REVIEW

As shown in Part I above, the Commissioner has failed to demonstrate a conflict between this Court's prior decisions, prior state-court decisions, and the decision of the Tennessee

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Hess should be limited to the context of sales and use taxes and that the benefit BLC derives from its possession of a certificate of authority—the opportunity to do business in Texas under the state's protection regardless of whether it chooses to exercise that privilege—constitutes the necessary "substantial nexus." The Supreme Court, however, addressed the flaw in this argument by stating that "there is no economic consequence that follows necessarily from the use of the particular words 'privilege of doing business', and a focus on that formalism merely obscures the question whether the tax produces a forbidden effect" under the Commerce Clause. *Complete Auto*, 430 U.S. at 288. Although written in the context of sales and use taxes, *Quill Corp.* and *Bellas Hess* do not purport to apply a standard other than the "substantial nexus" test applied in *Complete Auto* to a "privilege of doing business" tax in Mississippi.

Like BLC in the present case, the sole activity the foreign corporations in *Quill Corp.* and *Bellas Hess* conducted was by interstate commerce—communication by United States mail and common carriers. While the decisions in *Quill Corp.* and *Bellas Hess* involved sales and use taxes, we see no principled distinction when the basic issue remains whether the state can tax the corporation at all under the Commerce Clause. As construed in *Quill Corp.* and *Bellas Hess*, when the corporation conducts its activity solely through interstate commerce and lacks any physical presence in the state, no sufficient nexus exists to permit the state to assess tax.

18 S.W.3d at 299-300.

intermediate appellate court below. That should be enough to deny review. But there is an additional, and independent, reason that certiorari should not be granted here: This Court's intrusion would be particularly inappropriate at this time, when Congress is actively reviewing this area of state taxation of interstate commerce.

One of the fundamental reasons that this Court adopted and reaffirmed the bright-line physical-presence test in *Bellas Hess* and *Quill* was its recognition that "the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve" because "Congress has the plenary power to regulate commerce among the states." *Quill*, 504 U.S. at 305. Indeed, in the years leading up to *Quill*, Congress had considered and consistently rejected legislation that would "overrule" *Bellas Hess*. *See id.* at 318. In *Quill*, this Court removed the Due Process Clause nexus impediment to state taxation (which could not have been altered by Congress), and left in place the Commerce Clause's "substantial nexus" requirement (which could be altered by Congress). By doing so, the *Quill* Court invited Congress to intervene, stating that "Congress is now free to decide whether, when and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes." *Id.*

In fact, since *Quill*, Congress has considered and debated numerous legislative proposals, which only underscores the fact that adjusting the allowable burdens on interstate commerce involves delicate policy decisions and coordinated efforts among interested parties that are far more suited to congressional, rather than judicial, action and that have an impact far beyond the mail-order use-tax-collection context.

The fact that those extensive efforts have not yet resulted in enacted law is understandable, however, since the *Quill* decision came just as the Internet, and "e-commerce," was emerging onto the national (and international) scene. This new

commercial medium has presented Congress with new and complex issues to consider in the context of state-taxation nexus, and Congress has approached that subject with appropriate care and deliberation. In fact, Congress has become so alarmed at state efforts to push the constitutional envelope and expand their taxing jurisdiction into this area that it has imposed a three-year moratorium on "Internet related" taxes, during which the Advisory Commission on Electronic Commerce ("ACEC") will study this and related issues and make its recommendations. *See* Internet Tax Freedom Act of 1998, Pub. L. No. 105-277. While the primary focus of that Act is the Internet, the ACEC was created to study a wide variety of tax issues, including, among other options, the adoption of a uniform nexus standard for *all* taxes (income taxes, as well as sales and use taxes). Accordingly, the appropriate boundaries of state taxing jurisdiction are receiving a significant amount of national attention and careful study in the political branches, with many of the leading proposals urging a single nexus standard for all taxes.[11]

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[11] *See, e.g., Proposal of Governor James S. Gilmore, III* (Document No. 107 of the E-Commerce Commission Document Library located at *www.ecommercecommission.org*, which would adopt a physical presence standard for income and for sales and use taxes); *Proposal of Dean Andal, Vice Chairman of the California State Board of Equalization* (Document No. 64, which suggests the adoption of a "substantial physical presence" nexus standard for all state and local taxes). For other examples of Congress' ongoing efforts in this area, see, *e.g.*, S.1825, 103d Cong. (1994) (authorizing collection of certain state and local taxes with respect to the sale, delivery, and use of tangible personal property); S.545, 104th Cong. (1995) (same); H.R. 3039, 104th Cong. (1996) (proposing a national sales tax to be administered primarily by the states); Internet Tax Freedom Act, S.442, 105th Cong. (1998) (to impose a moratorium on new, multiple, or discriminatory state taxes on the Internet); Internet Nondiscrimination Act of 2000, H.R.3079, S.2028, & S.2255, 106th Cong. (2000) (to extend the Internet Tax Freedom Act until

What all of this demonstrates is that any conceivable confusion regarding the Commerce Clause's "substantial nexus" standard can be, and is likely to be, resolved by Congress in the near term. This Court should not accept the Commissioner's invitation to insinuate itself into the middle of this national debate, for such judicial intervention would surely stall the ongoing legislative efforts to develop a national nexus standard for all types of taxes. "In this situation, it may be that 'the better part of both wisdom and valor is to respect the judgment of the other branches of the Government.'" *Quill*, 504 U.S. at 318-19 (quoting *Commonwealth Edison Co.*, 453 U.S. at 637-38 (White, J. concurring)).

October 21, 2006); Internet Tax Reform and Reduction Act of 2000, H.R. 4267, 106th Cong. (2000) (to adopt certain recommendations of the ACEC); Internet Tax Simplification Act of 2000, H.R.4460, 106th Cong. (2000) (to adopt certain recommendations of the ACEC); New Economy Tax Simplification Act, S.2401, 106th Cong. (2000) (to adopt, based upon *Quill*, a uniform jurisdictional standard for nexus from Internet related business activities); Internet Tax Elimination Act, H.R.3252, 106th Cong. (2000) (to make the Internet a tax-free zone); Fair and Equitable Interstate Tax Compact Simplification Act of 2000, H.R.4462, 106th Cong. (2000) (to facilitate the states' creation of a streamlined sales tax collection system); Internet Tax Moratorium and Equity Act, S.2275, 106th Cong. (2000) (to extent the Internet Tax Freedom Act moratorium and promote the adoption of state sales tax simplification measures); *Interstate Use Tax Collection: Hearing Before the Senate Committee on Small Business*, 103d Cong. (1994); *Internet Taxation in the New Millenium: Hearing Before the Senate Budget Committee*, 106th Cong. (2000).

CONCLUSION

For these reasons, the Commissioner's petition for writ of certiorari should be denied.

Respectfully submitted,

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No. 00-205

IN THE

SUPREME COURT OF THE UNITED STATES

RUTH E. JOHNSON, COMMISSIONER OF REVENUE,
STATE OF TENNESSEE,
Petitioner,

v.

J.C. PENNEY NATIONAL BANK,
Respondent.

On Petition for Writ of Certiorari to the Court of Appeals of the State of Tennessee

Brief *Amicus Curiae* of Multistate Tax Commission In Support of Petitioner

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On Petition for Writ of Certiorari to the Court of Appeals of the State of Tennessee

Brief *Amicus Curiae* of Multistate Tax Commission In Support of Petitioner

The Multistate Tax Commission ("MTC") submits this brief as *Amicus Curiae* in support of granting the Petition for Writ of Certiorari under Rule 37.2 of the Court's Rules.[1]

INTEREST OF *AMICUS CURIAE*

The MTC is the administrative agency created by the Multistate Tax Compact ("COMPACT"). *See* RIA ALL STATES TAX GUIDE ¶ 701 *et seq.*, p. 751 (1995). Twenty-one States have legislatively established full membership in the COMPACT. In addition, two States

[1]No counsel for any party authored this brief in whole or in part. Only *Amicus* MTC and its full member States made any monetary contribution to the preparation or submission of this brief. Consent of all parties to the filing of this brief is filed concurrently with this brief.

are sovereignty members and nineteen States are associate members.[2] The Court upheld the validity of the COMPACT in *United States Steel Corp.* v. *Multistate Tax Comm'n*, 434 U.S. 452 (1978).

The COMPACT evolved out of concern of the States and multistate taxpayers about proposed federal legislation to regulate state tax systems following the findings and recommendations of the Willis Committee.[3] *See* D. Brunori, *Interview: Gene Corrigan, a 'Proud Parent' of the MTC*, 17 STATE TAX NOTES 1295 (November 15, 1999). The States' primary interest in forming the COMPACT was to preserve the States' taxing power in the context of multijurisdictional commerce, an essential governmental power if the States were to preserve their constitutional role.

The specific purposes of the COMPACT that fulfill its overall aim of preserving state tax sovereignty are

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[2] Compact Members: Alabama, Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Maine, Michigan, Minnesota, Missouri, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah and Washington. Sovereignty Members: Florida and Wyoming. Associate Members: Arizona, Connecticut, Georgia, Illinois, Kentucky, Louisiana, Maryland, Massachusetts, Mississippi, New Hampshire, New Jersey, North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, Tennessee, Wisconsin, and West Virginia.

[3] The Willis Committee, a congressional study of state taxation mandated by TITLE II, PUB. L. NO. 86-272, 73 STAT. 555, 556 (1959), made extensive recommendations as to how Congress could regulate state taxation of interstate and foreign commerce. See generally INTERSTATE TAXATION ACT: HEARINGS ON H.R. 11798 AND COMPANION BILLS BEFORE SPECIAL SUBCOMM. ON STATE TAXATION OF INTERSTATE COMMERCE OF THE HOUSE COMM. ON THE JUDICIARY, 89th Cong., 2d Sess. (1966).

(1) facilitation of proper determination of state and local tax liability of multistate taxpayers; (2) promotion of uniformity or compatibility in significant components of tax systems; (3) facilitation of taxpayer convenience and compliance; and (4) avoidance of duplicative taxation.

In furtherance of the purposes of the COMPACT, the MTC seeks a clarified understanding of the constitutional nexus standard for the imposition of income and net worth taxes. A clear nexus standard will advise those engaged in interstate commerce of the extent of their obligation to pay their fair share of state taxes. See *Oklahoma Tax Comm'n* v. *Jefferson Lines*, 514 U.S. 175, 184 (1995); *Barclay's Bank PLC* v. *Franchise Tax Bd.*, 512 U.S. 298, 310 (1994). An authoritative statement from this Court on the nexus standards for income and net worth taxes will also facilitate taxpayer convenience and compliance, because taxpayers will more readily understand the constitutional limits of the Commerce Clause with respect to these taxes. As detailed in the first part of the following argument, there is a compelling need for the Court to speak in the area at issue in this matter. Granting review will bring some order to an otherwise raucous free-for-all that presently exists in the face of the Court's silence.

REASONS FOR ALLOWING WRIT

I. THIS MATTER IS IMPORTANT TO OUR FEDERAL SYSTEM, BECAUSE

A. THERE IS A COMPELLING NEED FOR MEANINGFUL DIRECTION ON THE IMPORTANT ISSUE OF THE NEXUS STANDARD FOR INCOME AND NET WORTH TAXES;

The MTC urges the Court to review this case because it represents a pivotal opportunity for the Court to provide meaningful direction to the business community and the States.[4] The ever-simmering and important issue of constitutional nexus pertaining to taxes other than the imposition of a use tax collection obligation upon a remote business has become increasingly contentious. The issue stated here is most fundamental, going far beyond the constitutionality of some limited element of an operating income tax. See *Hunt-Wesson, Inc.* v. *Franchise Tax Bd.*, 528 U.S. ____, 120 S. Ct. 1022 (2000) (operation of interest offset provision within state income tax ruled unconstitutional). The very core of state taxing power is at issue—what connection must a remotely operated business have with a taxing State in order to support jurisdiction to im-

[4] Your *Amicus* is not enchanted with describing one of the parties for whom meaningful direction from the Court would be beneficial as "the States." The term does not readily admit that "the States" is an abstraction representing the people collectively within the body politic. The true beneficiaries of clear understanding of nexus principles are not the state legislatures, state executives, or state tax administrators, but the citizens of the several States themselves.

pose an income tax and a net worth tax as distinguished from the imposition of a use tax collection obligation.

The specific issue can properly be stated as, "Is some sort of 'physical presence' required before a State, consistent with the dormant Commerce Clause, may impose an income tax and/or a net worth tax with respect to a financial institution that maintains established, ongoing, contractual relationships with its customers in the taxing State."

The ongoing and contractual nature of the contact that is at issue in this case is, of course, far different from the intermittent catalog purchases presented in *National Bellas Hess, Inc.* v. *Dept. of Revenue*, 386 U.S. 753 (1967), and *Quill Corp.* v. *North Dakota*, 504 U.S. 298 (1992)). But this observation does not mean this matter with this unique factual aspect is of interest only to States that have asserted taxing jurisdiction over newly emerging, centrally organized, and remotely operated financial institutions. (This issue nonetheless is important to the States that have recognized the changing reality that banking and related financial services are increasingly provided by remotely organized and operated institutions. See Randall J. Pielsnik, *State Taxation of Multistate Banking Operations—A State by State Analysis, Parts 1 and 2*, 18 J. STATE TAX. 40 (SUMMER 1999), and 60 (FALL 1999), republished in 17 STATE TAX NOTES 383 (AUGUST 9, 1999) and DOC. 1999-34495 (SEPTEMBER 15, 1999) (electronic).)[5]

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[5] In assessing the degree to which remotely operated financial institutions are currently subject to state tax, one must recall that "[b]ecause of a long history of Federal restrictions, . . . state taxation of banks was essentially a residence-based system." STATE AND LOCAL TAXATION OF BANKS AND OTHER FINANCIAL INSTITUTIONS at v

As has been noted by others, state taxation of other operations not involving the financial institution industry is also at risk. See esp., *e.g.*, *In Matter of KMart Properties, Inc.*, N.M. Dept. of Taxation & Rev. Admin. Hearing No. 00-04 (Feb. 1, 2000), on appeal, *sub. nom.*, *Kmart Properties, Inc.* v. *Taxation & Revenue Dept.*, N.M. Court App. No. 211440 (expansive discussion of widely used tax planning technique (the "passive income company" or "PIC" plan) to divert revenue to separately incorporated entity holding trademarks and other intangibles).

The passive income company plan shows how far awry the application of the *Bellas Hess* and *Quill* "physical presence" test to income taxes has gone.

(AM. BAR ASS'N, SECTION OF TAXATION, 1995-96 ED.). Following revolutionary changes in the statutory governance of the banking system, including passage of the Riegel-Neal Interstate Banking and Branching Efficiency Act of 1994, PUB. L. 103-328, 108 STAT. 2338, financial institutions have pursued a more centralized, remotely directed business plan. In light of these changes, States have begun to modernize their state taxing systems to reflect more market-state orientation, including jurisdiction. TAXATION OF BANKS, above, at v. Also, in evolutionary terms of impacting *all* state tax systems, it has not been that long since Congress adopted a statutory declaration that States could impose an income tax on national banks. Secs. 1 and 2, PUB.L 91-156 (1969).

Nevertheless, several of the States as noted in the article cited in the text and the ABA book cited in this note have affirmatively extended their bank taxes to remotely operated banks. Several other States have statutory standards of nexus that offer the potential to support the same result. These standards include "doing business," "deriving income," receiving interest on loans secured by property in the State, concepts of business situs, obtaining or soliciting business, and constitutionally permitted jurisdiction.

The PIC plan essentially assumes that a single enterprise can self-deal among its own affiliates and thereby achieve non-taxation of income, because the affiliate (the PIC) holding the intangibles that are licensed under a royalty agreement for use in the taxing State is allegedly not "physically present" in that State. Your *Amicus* is unable to identify how preservation of a tax-exemption of an affiliated PIC through application of a "physical presence" rule upholds the constitutional value of unburdened interstate commerce. What application of the physical presence rule to PIC plans shows is that *Bellas Hess* and *Quill* have become planning tools justifying extensive (and presumably expensive) planning of corporate organizational and operational structure in order to defeat a legitimate tax. This result cannot be justified under the dormant Commerce Clause. As the Court has observed, "[t]he importance of the commerce clause to the Union is very great. But it is also important to prevent that clause being used to deprive the States of their lifeblood by a strained interpretation of facts." *Superior Oil Co.* v. *Mississippi*, 280 U.S. 390, 395 (1930) (Holmes, J.). We would also add given the planning technique rejected in *Superior Oil* that the Court also intended that strained tax planning under the Commerce Clause not be used to deprive the States of critical tax revenues.

If the PIC plan were not enough, the emerging deregulation of utility services is another area where long-established state taxation is potentially at risk. The increasingly deregulated electricity industry is one case in point. Commentators indicate nexus is at issue in the remote sale of electricity. See Deloitte & Touche LLP, FEDERAL, STATE AND LOCAL TAX IMPLICATIONS OF ELECTRIC UTILITY INDUSTRY RESTRUCTURING, AN ANALYSIS FOR THE NATIONAL COUNCIL ON

COMPETITION AND THE ELECTRIC INDUSTRY at 20-21 (October 1996).

Besides impacting the power of the States to impose income and net worth taxes on remote operations, other than the imposition of a use tax collection obligation, there are other considerations that make this case an ideal candidate for the Court's attention. The crisp and clear statement of the issue presented buttresses our enthusiasm for this case. The MTC welcomes Commissioner Johnson's active pursuit of the precise issue here presented in fully and properly developed proceedings in the court system of Tennessee. This case affords a proper platform for this Court to evaluate the merits of the positions taken.

B. WITHOUT AN AUTHORITATIVE STATEMENT OF THE COURT ON THE IMPORTANT NEXUS ISSUE PERTAINING TO INCOME AND NET WORTH TAXES, THE INTEGRITY OF STATE TAX SYSTEMS IS AT RISK.

The integrity of the state tax system is also implicated by the assertion that the "physical presence" test is broadly applicable to all forms of state taxation. This assertion is one that has been left unanswered far too long. The negative aspects of letting this issue continue to fester are clear. Taxpayers in the face of the cacophony of claims of tax immunity are puzzled by what they should do. Should they be governed by the likelihood of a challenge to their reporting position and the likely outcome of that challenge or by competitive pressures whose close ally, the political process, will ensure that the sting of losing on compliance is not too severe?

Disrespect for state tax systems has increased because the States lack an authoritative statement of this Court. In many respects following *Quill*, state tax systems have lost credibility with taxpayers in general. Some background on this observation in order.

The Court and Congress have let the nexus stand-off simmer unchanged, since this Court rendered its decision in *Quill*. With the Court on the sidelines, the States' only recourse has been pursuit of litigation to provide evidence that what they preach is sound. But litigation is piecemeal at best. The other option of providing a reasoned assessment of reporting obligations outside of litigation are shouted down in the absence of an authoritative statement of the Court. See Richard D. Pomp and Michael J. McIntyre, *State Taxation Of Mail-Order Sales Of Computers After* Quill*: An Evaluation Of MTC Bulletin 95-1*, 11 STATE TAX NOTES 177 (JULY 15, 1996), that analyzes the soundness of *Multistate Tax Comm'n Nat'l Nexus Prog. Bull. 95-1*, republished at 10 STATE TAX NOTES 62 (JANUARY 1, 1996), that met stiff, if not hostile, opposition.

The absence of any authoritative statement of the Court has emboldened respected representatives of taxpayers to make what your *Amicus* views as questionable statements of the governing principles of nexus as to income taxes. These statements include assertions that pre-*Quill* due process nexus cases are not binding precedent for understanding the requirements of the Commerce Clause, Kendall L. Houghton & Douglas L. Lindholm, *COST Opposes MTC Nexus Bulletin 95-1*, 10 STATE TAX NOTES 973, 974 (MARCH 25, 1996); neither the MTC nor the States may interpret existing Supreme Court precedent to support nexus positions in the absence "irrefutable" precedent, *Id.* at 977; by use of the

descriptive phrase, "furthest extension," similar to "furthest constitutional reach" used in *Bellas Hess*, 386 U.S. at 757, *Quill* intimated in 1992 that there has been movement away from *Scripto, Inc.* v. *Carson*, 362 U.S. 207 (1960), *Id.* at 975; and there is no substantive constitutional difference between nexus to support a use tax collection obligation and a net income tax obligation. Fred O. Marcus, *Limitations on States' Jurisdiction to Impose Net Income Based Taxes* 1410:0007, TAX MANGMT. MULTISTATE TAX PORTFOLIO (BNA 2000).

The nexus stand-off largely continues today unabated. Causes for not making much progress include (i) a generally hostile tax environment; (ii) the States' apparent failure in the hostile environment to convince taxpayers of the soundness of their position in circumstances not yet fully developed by the nexus precedent of the Court; (iii) a lack of appropriated funds to support wide-spread litigation that is required to cut the "Gordian knot" of nexus; (iv) the emergence of the electronic commerce industry that for now appears largely opposed to most government regulation, including taxation; and (v) the reluctance of some state courts in the face of *Quill* to analyze nexus issues afresh for fear of overstepping bounds perceived to have been established by this Court. As to item (v), see Argument II, below.

That a stand-off continues following *Quill* is not totally unexpected, since both tax administrators and taxpayers had placed so much anticipation on the outcome of *Quill*. As has been observed elsewhere, what was really needed following *Quill* was less *legal* counsel and more *psychological* counsel. "Tax administrators required counseling to overcome negative thinking attributable to the understandable depression caused by the loss in *Quill*; practitioners, on the other hand, needed counseling

to ground themselves in reality following their manic high that came from the *Quill* victory." Paull Mines, *Conversing with Professor Hellerstein: Electronic Commerce and Nexus Propel Sales and Use Tax Reform*, 52 TAX L. REV. 581, 604 n.124 (1997).

But even though the continuing stand-off is understandable, the overreaction to *Quill* is curious. The holding of *Quill*, a reaffirmation of *Bellas Hess*, is quite limited. A simple, but accurate, statement of the holding of *Bellas Hess* which *Quill* reaffirmed is that a State may not impose a *use tax collection obligation* on a remote seller whose contact is limited to common carrier and the U.S. mail. 386 U.S. at 758. *Quill* repeated this holding at least five times. 504 U.S. at 301 (first paragraph of opinion), 307, 311 (two occurrences), and 315. The Court describes this principle as the physical presence requirement. 504 U.S. at 311 ("*Bellas Hess*' 'sharp distinction'"), 314 (*Bellas Hess* established physical presence requirement), and 317 (*Bellas Hess* physical presence requirement) The Court also expressly limited the application of *Quill* by noting that it had not applied the same "physical presence" requirement to other taxes. 504 U.S. at 314 and 317.

We believe, therefore, the Court should use this case for its potential to provide an authoritative and balanced assessment of the applicability of *Bellas Hess* and *Quill* in areas outside of the use tax collection obligation. In seeking intervention of the Court, the MTC is not so bold as to believe that the Court will necessarily agree with the emerging understanding of the States as to appropriate nexus requirements for income and net worth taxes. But the Court remains the final arbiter of the content of the dormant Commerce Clause and the MTC views the opportunity to have amplification of nexus rules in the context of the taxes at issue here better than

to allow state tax systems to atrophy through the continued stand-off that currently exists.

II. THE COURT SHOULD INSTRUCT STATE COURTS THAT THEY MAY NOT ABDICATE THEIR RESPONSIBILITY TO GIVE FULL AND FAIR CONSIDERATION OF FEDERAL CONSTITUTIONAL ISSUES PROPERLY RAISED IN STATE TAX MATTERS.

The MTC is disturbed by the refusal of the Tennessee Court of Appeals to address whether the "physical presence" standard of nexus applicable to the imposition of a use tax obligation on a remote seller applies to the taxes here at issue. The Court dismissed the tax administrator's argument that *Bellas Hess* and *Quill* were inapplicable with the observation,

> However, we are not in a position to speculate as to how the Supreme Court might decide future cases. We are only able to rely on past decisions. Any constitutional distinctions between the franchise and excise taxes presented here and the use taxes contemplated in *Bellas Hess* and *Quill* are not within the purview of this court to discern. As such, we feel that the outcome of this case is governed by *Bellas Hess* and *Quill*, as those decisions interpret the first prong of the *Complete Auto* test.

The MTC sees taxpayers themselves now urging this approach to constitutional adjudication in state court systems. App. Furnitureland Reply Br. 20 in *Furnitureland South, Inv.* v. *Comptroller of Treasury*, now pending, Md. Ct. App. No. 6 (September Term 2000) (province of U.S. Supreme Court and Congress to determine meaning of "common carrier" in

Bellas Hess and *Quill* safe harbor). The Court should take this case to remind the state courts of their constitutional responsibility within our federal system to address properly raised constitutional issues.

Refusal of a state court to address properly raised constitutional issues fully and fairly is unacceptable in our federal system where the first instance of constitutional understanding pertaining to state taxes is largely reached in the state court system. 28 U.S.C. § 1341 (1994) (Tax Injunction Act). The approach of the Court of Appeals also unjustifiably results in holding the indispensable state taxing power hostage to a presumption against the state taxing power, when, if anything, the presumption should operate in the opposite direction.

No one can seriously question the competence and duty of the state courts to decide constitutional issues. *Arkansas* v. *Kansas & T. Coal Co.*, 183 U.S. 185, 190-91 (1901); *cf. Alden* v. *Maine*, 527 U.S. 706, 755 (1999) (good faith state application of Constitution implements supremacy clause). Of course in applying the Constitution, a state court must adhere to the precedent of the Supreme Court to the extent they exist. *Chesapeak & O. Ry. Co.* v. *Martin*, 283 U.S. 209, 221 (1931).

The problem with a state court abdicating the responsibility to resolve constitutional issues properly raised is that it leaves the litigants at the mercy of a default rule the court would adopt to avoid deciding the constitutional issue. In this case, abdication meant a ruling in favor of a remote bank in the absence of a precise precedent of the Court. This kind of decision-making ensures that the state tax administrators will never succeed in state courts with respect to reasonable interpretations of constitutional limitations on state taxing power in the ab-

sence of a precise and controlling precedent. But application of this kind of default rule is unwarranted and unsupportable by the jurisprudence of the Court.

In the first place, the Court long ago recognized the importance of state taxation as an element of state sovereignty in our federal system. *McCulloch* v. *Maryland*, 17 U.S. (4 Wheat.) 316, 428-29 (1819) ("All subjects over which the sovereign power of a state extends are objects of taxation."); *Travis* v. *Yale & Towne Mfg. Cos.*, 252 U.S. 60, 75 (1920) (state may impose tax upon the incomes of nonresidents arising from any business, trade, profession, or occupation carried on within its borders).

Further, the Court has clearly established that interstate commerce is not immune from state tax and interstate commerce must pay its fair share of taxes. E.g., *Oklahoma Tax Comm'n* v. *Jefferson Lines, Inc.*, 514 U.S. 175, 184 (1995); *D.H. Holmes Co.* v. *McNamara*, 486 U.S. 24, 31 (1988). "[I]t was not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of [the] state tax burden even though it increases the cost of doing business." *Commonwealth Edison Co.* v. *Montana*, 453 U.S. 609, 623 - 624 (1981); *Western Live Stock* v. *Bureau of Revenue*, 303 U.S. 250, 254 (1938).

Additionally, the Court clearly operates from the premise that the burden to establish any exemption, including exemptions based upon constitutional principles, rests on the taxpayer. *Norton Co.* v. *Dept. of Revenue*, 340 U.S. 534, 537 (1951) (limited as to other matters in *National Geographic Soc'ty* v. *California Bd. of Equalization*, 430 U.S. 551, 560 (1977)); see also, *General Motors Corp.* v. *Washington*, 377 U.S. 436, 441-42 (1964); *Container Corp. of*

America v. *Franchise Tax Bd.*, 463 U.S. 159, 175-76 (1983).

The bias that might be described as favoring state taxing power even in the face of a constitutional challenge is closely allied with the important recognition of the Supreme Court that state taxing power is an essential element of state sovereignty. *Wisconsin* v. *J.C. Penney Co.*, 311 U.S. 435, 444 (1940); *National Private Truck Council, Inc.* v. *Oklahoma Tax Comm'n*, 515 U.S. 582, 587 (1995), *quoting Dows* v. *City of Chicago*, 11 Wall. 108, 110 (1871) ("It is upon taxation that the several States chiefly rely to obtain the means to carry on their respective governments, and it is of the utmost importance to all of them that the modes adopted to enforce the taxes levied should be interfered with as little as possible.") Without the power to tax, States are left with no resources to discharge their governmental responsibility in our federal union. See *Department of Revenue* v. *ACF Industries, Inc.*, 510 U.S. 322, 345 (1994) (considerations of federalism support view that tax system not proscribed). As the *ACF Industries* further illustrates, considerations of federalism are so strong that they influence interpretation of a possible restriction based upon a congressional statute validly enacted under the Commerce Clause whose express intent is to regulate state taxing power. See also *Gregory* v. *Ashcroft*, 501 U.S. 452 (1991) (clear or plain statement rule applied).

In the face of this fundamental understanding, the MTC does not believe a state court facing a properly raised constitutional issue can avoid its responsibility to do the best it can by ruling against the state taxing power. In sum, we submit the Tennessee Court of Appeals should have been guided by the strong presumption that the Court does not

lightly undermine state taxing authority. See *Superior Oil Co.* v. *Mississippi*, 280 U.S. 390, 395 (1930).

CONCLUSION

Upon the foregoing and other arguments that have been presented to the Court, *Amicus Curiae* Multistate Tax Commission respectfully urges the Court to grant the Petition and issue a writ of certiorari to the Court of Appeals of the State of Tennessee.

Respectfully submitted,

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No. 00-205

In the

Supreme Court of the United States

Ruth E. Johnson, Commissioner of Revenue,
State of Tennessee,

Petitioner,

v.

J.C. Penney National Bank,

Respondent.

On Petition for a Writ of Certiorari to the Court of Appeals of Tennessee

Brief of the States of New Jersey, Alaska, Colorado, Florida, Idaho, Illinois, Iowa, Maryland, Michigan, Missouri, Montana, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, and Utah as Amici Curiae in Support of Petitioner

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QUESTION PRESENTED

May a State, in accordance with the nexus requirements of the Commerce Clause, impose franchise and income-based taxes on corporations that derive significant economic benefits from regular and continuous activities conducted in that State through means of interstate commerce, even though those corporations lack the physical presence in the State that this Court required in *National Bellas Hess, Inc. v. Department of Revenue* and *Quill Corporation v. North Dakota* for imposing a use-tax-collection duty?

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STATEMENT OF AMICI INTEREST

The amici States have substantial interests in determining the extent to which the Commerce Clause permits the imposition of State corporate franchise and income-based taxes on entities that derive significant economic benefits from conducting business in States in which those entities do not have a physical presence. Corporate franchise and income-based taxes are indispensable components of many States' budgets, generating essential revenue to pay the costs of services provided to corporations that conduct business in the States, as well as to maintain the infrastructure necessary for interstate commerce. Forty-six States impose these taxes on corporate entities. CCH Multistate Corporate Income Tax Guide ¶196. The lower court decision seriously restricts a State's ability to collect taxes from businesses that avail themselves of the State's services and reap the benefits of the State's maintenance of a marketplace merely because those entities are not physically present in the State.

The corrosive impact of such a restrictive interpretation of the Commerce Clause on State taxing authority will grow as the explosion in technological advances continues to make it easier for enterprises to conduct business in a particular location without being physically present there. With each passing day, the correlation between where a company's physical assets are located and where that company derives its profits becomes increasingly remote. With those changes, a Commerce Clause standard based on the physical presence of a taxpayer becomes obsolete and unworkable. This Court's Commerce Clause jurisprudence, and the States' ability to collect revenue from corporations that benefit from State services, should evolve along with modern business practices and take into account the growing irrelevance of a corporation's physical presence to its business transactions.

The importance of this issue to the States is highlighted by the number of recently decided and currently pending disputes raising the question of the States' authority to impose corporate franchise and income-based taxes on entities that

conduct business in jurisdictions in which they are not physically present. Tennessee's petition details several recent published opinions grappling with the issue of whether this Court intended for the holding in *Quill* to be freed from its moorings in the sales tax context and applied to all manner of State taxes. The amici States bring to the Court's attention several additional cases involving this issue that are pending in administrative or judicial bodies and which might otherwise escape the Court's notice because they have not yet generated published opinions. In light of the importance of the issue presented in the petition and the extent of the current controversy over the scope of State taxing authority in this area, the amici States join Tennessee in urging the Court to grant certiorari.

REASONS FOR GRANTING THE WRIT

Review of the question presented by the petition is a matter of critical importance to the States because an overly restrictive interpretation of the Commerce Clause will preclude States from collecting properly apportioned franchise and income-based taxes from corporations that purposely avail themselves of economic opportunities in a particular State while studiously avoiding physical presence there. The impact of such a rule on State tax revenue will only magnify as the breakneck pace at which modern business practices are developing continues and business transactions become less and less dependent on physical interaction and location to conduct business. As the need to carry out business through physical contact fades into obscurity, a physical-presence requirement for the imposition of State franchise and income-based taxes, which may once have made sense, will become increasingly archaic and unfair to the States, which will nonetheless be required to continue to provide the services and infrastructure necessary to maintain profitable marketplaces for business endeavors.

The important objectives served by the collection of those levies will be directly hindered if the Commerce Clause is interpreted in too strict a fashion and the States are excluded from collecting tax revenue from the very business enterprises that reap the benefits of State services and protection merely because those businesses lack a physical presence in the taxing jurisdiction. The maintenance of the infrastructure necessary to accommodate interstate commerce, as well as the provision of a judicial system to protect and enforce commercial transactions, are but two of the many valuable services provided by States to business entities, whether or not those entities have physical property in the States in which they exploit the marketplace for profit.

As described more fully below, the scope of Commerce Clause limitations on State corporate taxation is an unsettled question. Many States are actively seeking a judicial determination of the extent to which they may impose franchise and income-based taxes on entities that earn profits in their jurisdictions without being physically present there. State court decisions in this area are in disarray. This Court's intervention is necessary to provide guidance to the States on a topic of vital importance to their economic stability and their ability to provide essential governmental services. The petition for certiorari should be granted.

I. MANY STATES ARE ACTIVELY SEEKING TO RESOLVE THE UNSETTLED QUESTION PRESENTED BY THE PETITION.

The question of whether the bright-line, physical-presence test established in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), applies to State taxes outside the use-tax context is under active dispute in several States. In its petition, Tennessee points to numerous published opinions espousing conflicting views on the applicability of the *Quill* physical-presence test to various State taxes. Some courts have faithfully abided by this Court's limitation of the holding

in *Quill* to the use-tax context. *See Couchot v. State Lottery Comm'n*, 659 N.E.2d 1225 (Ohio), *cert. denied*, 519 U.S. 810 (1996) (holding *Quill* physical-presence test not applicable to State income tax on non-residents); *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13 (S.C.), *cert. denied*, 510 U.S. 992 (1993)(declining to extend *Quill* physical presence test to corporate franchise taxes); *Borden Chemicals & Plastics, LP v. Zehnder*, 726 N.E.2d 73 (Ill. App.)(holding *Quill* physical-presence test does not preclude application of State income tax to members of non-resident partnership), *app. denied*, 731 N.E.2d 762 (Ill. 2000).

Other courts, including the court below, have extended *Quill*'s limitation on State taxing authority to other forms of taxation. *See Guardian Indus. Corp. v. Department of Treasury*, 499 N.W.2d 349, 356 (Mich. App. 1993)(holding that "after Quill, it is abundantly clear that [a State] must show a physical presence . . . to establish substantial nexus to tax it."), *app. denied*, 512 N.W.2d 846 (Mich. 1994); *MCI Int'l Telecommunications Corp. v. Comptroller of the Treasury*, 1999 WESTLAW 322702 (Md. Tax Ct. 1999), *aff'd*, 2000 STT["State Tax Today"] 60-22 (Md. Cir. Ct. March 17, 2000)(applying physical presence type test to corporate income tax); *Cerro Copper Products, Inc. v. Alabama Dept. of Revenue*, No. F94-444 (Ala. Adm. Judge, Dec. 11, 1995), State Tax Notes, Jan. 1, 1996, at 65, 66 (holding that taxpayer which lacks sufficient nexus with State for sales and use tax purposes also lacks sufficient nexus for corporate franchise tax purposes).

Tennessee's petition actually understates the extent to which the issue is presently in dispute in the State courts. Numerous other challenges to the imposition of State taxes based on the taxpayer's purported lack of physical presence are pending in State administrative and judicial tribunals.

New Jersey is defending imposition of its Corporation Business Tax, *N.J. Stat. Ann.* §54:10A-1, *et seq.* (West

2000), to a corporation that profits from the use of its intangible property -- trademarks, service marks, and tradenames -- in that State but has no physical presence there. *Lanco, Inc. v. Director, Div. of Taxation*, N.J. Tax Court, Docket No. 005329-1997. A similar action is pending in Iowa, where that State seeks to impose its corporate income tax on an entity that receives royalties from the use of its trademarks and tradenames in Iowa but is not physically present in the State. *In re: Pepisco, Inc. & Affiliates*, Iowa Department of Revenue and Finance, Docket No. 99-24-1-0130. The same issue is presently in dispute in New Mexico, where that State seeks to collect its corporate franchise and income taxes on a corporation that receives royalties for the use of its intangible property -- the trademarks and tradenames associated with K-Mart Stores -- in New Mexico but has no physical presence there. *In re: Kmart Properties, Inc.*, New Mexico Taxation and Revenue Department, Docket No. 00-04. The Massachusetts Appellate Tax Board recently permitted the taxation of a trademark holding company with no physical presence in the Commonwealth only after finding that the company's creation was a sham carried out by a separate entity that was physically present there. *Sherwin-Williams Co. v. Commissioner of Revenue*, Docket No. F233560.

The existence of so many active disputes concerning the applicability of the *Quill* physical-presence test to various State taxes highlights the need for this Court's review of the decision below. The significance of obtaining certainty in this area of unquestioned importance to the provision of vital State services has prompted a large number of States to seek judicial guidance on the scope of their corporate taxing authority in light of the holding in *Quill*. The published opinions generated to date demonstrate the division among the lower courts on this important question. The number of pending actions raising the issue underscores the exceptional significance attributed to this question by the States. A decision by this Court on Tennessee's appeal would bring

much-needed clarity and resolution to an area of overriding State concern.

II. THE PHYSICAL-PRESENCE TEST ARTICULATED IN *QUILL* IS INCOMPATIBLE WITH MODERN BUSINESS PRACTICES AND ITS APPLICATION TO THE AREA OF STATE CORPORATE FRANCHISE AND INCOME-BASED TAXES IS UNWARRANTED.

The confusion that reigns among State courts is not surprising. Eight years ago, Justice White predicted that there would be a deluge of litigation concerning the meaning of the substantial nexus test articulated in *Quill*. 504 U.S. at 331 (White, J., concurring in part and dissenting in part). The storm has arrived. The Tennessee Court of Appeals is just the most recent State court that finds itself seeking a principled and reasonable analysis of the Commerce Clause in the modern business environment. Unfortunately, the lower court is also only the most recent tribunal to stray from the true tenets of the Commerce Clause by focusing inappropriately on the physical presence of the business in the taxing State rather than on the impact on interstate commerce resulting from application of a particular tax. It is time to clarify the permissible scope of State taxation under the Commerce Clause.

The Commerce Clause grants to Congress the power to regulate interstate commerce, thereby implicitly prohibiting States from taking action that impedes interstate commerce. *U.S. Const.* Art. I, § 8, cl. 3; *Quill*, *supra*, 504 U.S. at 309. Specifically, States are barred from discriminating against interstate commerce or unduly burdening interstate economic activity. *Id.* at 312. However, businesses engaging in interstate commerce may be required to bear their fair share of the cost of the State governments, whose protection and services they enjoy. *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753, 756 (1967). Hence, the central inquiry of a Commerce Clause challenge to the application of

a State tax statute should not be whether the business has a presence in the taxing State but, rather, whether application of the tax unduly interferes with interstate commerce. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 285 (1977).

In *Complete Auto*, this Court described a State tax that does not produce forbidden results: "net income from the interstate operations of a foreign corporation may be subjected to state taxation, provided the levy is not discriminatory and is properly apportioned to local activities within the taxing State forming sufficient nexus to support the tax." *Id.* at 285. The Court broke this rule down into four parts: a State tax does not contravene the Commerce Clause if it "[1] is applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State." *Id.* at 279. The four prongs are designed to flesh out the relationship between the taxing State and the activities conducted there by the business; the potential for multiple taxation on the same activity; the difference, if any, between the tax imposed on intrastate activities or in-state businesses and that imposed on interstate activities or out-of-state businesses; and the State services the business may avail itself of in the course of its business activities.

This test was applied in the context of use tax on an out-of-State mail order house in *Quill*. There, the Court explained that prongs one and four of the *Complete Auto* test, that there be a substantial nexus between the activity and the taxing State, and that there be a relationship between the tax and the services provided by the State, "limit the reach of state taxing authority so as to ensure that state taxation does not unduly burden interstate commerce." *Quill*, *supra*, 504 U.S. at 313 (footnote omitted). Prongs two and three "prohibit taxes that pass an unfair share of the tax burden onto interstate commerce." *Id.* at 313.

The first-prong "substantial nexus" requirement is "informed . . . by structural concerns about the effects of state regulation on the national economy." *Id.* at 312. However, subsequent case law, including the decision below, demonstrates that the first prong of the *Complete Auto* test is too frequently addressed in isolation, de-coupled from concerns about the potential effects of the State tax on the national economy. This approach threatens to stretch the *Complete Auto* test beyond its intended purposes to permit State tax laws to be struck down purely on the basis of a factual inquiry into whether the corporate taxpayer is physically present in a State, rather than based on a reasoned analysis of whether application of a particular State tax has a detrimental effect on interstate economic activity.

Moreover, the *Quill* decision appears to be less an analysis of modern business practices than a reflection of the importance of *stare decisis* in the context of State use taxes, an area in which a physical-presence test was established twenty-five years earlier in *National Bellas Hess*. While this Court in *Quill* was loyal to the *stare decisis* effect of the *National Bellas Hess* physical-presence test, the rule's limited analytical usefulness was acknowledged. This Court explained that the bright-line test is "artificial" but excusable because vendors had relied on the fact that under *National Bellas Hess* a State may not impose a use-tax collection requirement on a corporation unless it had a physical presence in the State. *Id.* at 315. However, given the rapid evolution of commercial activity, the Commerce Clause is no longer amenable to bright-line tests and is better addressed by a balancing of interests presented when a State franchise or income-based tax is imposed on a corporation which lacks physical presence in the taxing State.

If the Commerce Clause is to be realistically applied in today's business climate, courts must "look[] past 'the formal language of the tax statute [to] its practical effect'" and determine whether its application actually burdens interstate

commerce or discriminates against economic activity. *Id.* at 310 (quoting *Complete Auto*, *supra*, 430 U.S. at 279). The bright line drawn in *Quill* in the use-tax collection context is anachronistic and ignores the modern reality of interstate businesses. The use of this test for State corporate franchise and income-based taxation will stunt the evolution of Commerce Clause jurisprudence, as courts will be precluded from engaging in the type of balancing of interests more appropriate for today's changing economic environment.

Physical presence in a State does not necessarily signify a significant degree of business activity there. By the same token, with modern advances in communications and transportation, an entity's physical presence in a State is not at all determinative of the corporation's ability to receive substantial economic benefits from the State's marketplace. Simply put, in today's world of high speed, remote communications, physical presence becomes increasingly irrelevant with each passing day.

This Court has already recognized the insignificance of a business' physical presence in a taxing State for Due Process Clause purposes. This Court "abandoned more formalistic tests that focused on a defendant's 'presence' within a State in favor of a more flexible inquiry . . . ." *Id.* at 307. "In 'modern commercial life' it matters little that such solicitation is accomplished by a deluge of catalogs rather than a phalanx of drummers: The requirements of due process are met irrespective of a corporation's lack of physical presence in the taxing State." *Id.* at 308.

The rationale for abandoning a physical-presence requirement for Due Process Clause purposes recognizes that businesses engage in significant levels of commercial activity in a State without ever "setting foot" there. Enterprises readily foresee being subject to State laws, including tax laws, as a result of their commercial activity directed at a particular State. *See Burger King Corp. v. Rudzewicz*, 471 U.S. 462,

476 (1985). There is no principled reason why the Commerce Clause should require a corporation's physical presence to justify State taxation, provided the State can establish that the corporation derives significant benefits from continued and deliberate economic activity in the taxing State. Surely, business entities benefit from a well-maintained transportation and communication infrastructure that allows the wheels of interstate commerce to turn and from the protection accorded commercial transactions by a State's judicial system.

A sharper focus should be placed on the Commerce Clause inquiry: whether the activities of the business have a sufficient connection with the taxing State and whether the level of economic activity is such that the entity reasonably should expect to draw on State protection and services and, in turn, to pay for that protection and services. The remaining elements of the *Complete Auto* test -- that the tax is fairly apportioned, non-discriminatory against interstate commerce, and fairly related to the services provided by the taxing State -- ensure that companies that engage in intrastate activity will not be favored over interstate economic actors, fully effectuating the purposes of the Commerce Clause.

The potential burden on interstate commerce that appeared to worry this Court in *Quill* was the threat of imposition of use-tax collection obligations on out-of-State businesses by the large number of jurisdictions that impose the tax. As this Court noted, in 1992, at least 6,000 jurisdictions imposed use tax, and many required collection of the tax multiple times a year. *Quill*, *supra*, 504 U.S. at 313, n. 6. The administrative cost to an out-of-state seller of complying with thousands of distinct taxing jurisdictions might be significant, although with the availability of modern computer technology even that assumption is suspect. Corporate franchise and income-based taxes, on the other hand, are imposed by only 46 States and 2 jurisdictions and are likely to be collected annually. CCH Multistate Corporate Income Tax Guide ¶196. Moreover, these taxes are

apportioned to receipts from business conducted in the taxing State and many of the taxes are based on the annual income already reported by the corporations for federal tax purposes. Approximately forty-four States use this measure. CCH Multistate Corporate Income Tax Guide ¶125. The realities of State corporate franchise and income-based taxes simply do not threaten to impose a meaningful administrative burden on interstate economic actors.

It is time to reevaluate the Commerce Clause in the State corporate franchise and income-based tax context, and provide States with appropriate guidance in this important area. Technology has progressed in quantum leaps and bounds in the eight years since *Quill* and the twenty-three years since *Complete Auto* were decided. The States have a demonstrated need for a decision from this Court outlining the parameters of their taxing authority in the increasingly common circumstance in which a corporation earns significant profits in a State without being physically present there.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

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Dated:
September 5, 2000

(5)

No. 00-205

In the

Supreme Court of the United States

RUTH E. JOHNSON, COMMISSIONER OF REVENUE, STATE OF TENNESSEE,

Petitioner,

v.

J.C. PENNEY NATIONAL BANK,

Respondent.

On Petition for Writ of Certiorari to the Court of Appeals of Tennessee

REPLY TO BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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REPLY TO BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

Petitioner Ruth E. Johnson, Commissioner of Revenue, State of Tennessee, submits this Reply Brief in support of her Petition for Writ of Certiorari.

I.

THE DECISION BELOW IS NOT "FACTBOUND" AND CLEARLY APPLIES A "PHYSICAL PRESENCE" RULE.

Contrary to the claims of Respondent J.C. Penney National Bank ("JCPNB"), the Tennessee Court of Appeals addressed the fundamental constitutional issue before it in comprehensive terms that are not narrowly confined to this case. The Tennessee court's decision does not turn on any idiosyncratic feature of JCPNB's business, but on the holding that its lack of physical presence in Tennessee deprives the State of nexus to tax it under the Commerce Clause. There is nothing particularly remarkable about JCPNB's business, except its studied effort to avoid establishing a physical presence in Tennessee. It would, in fact, be hard to imagine a case in which there were more generic facts than this one,[1] or in which a court used broader constitutional concepts and doctrines to address those facts.

Any reasonable reading of the Tennessee court's decision evidences that its holding is based on its conclusion that JCPNB was not physically present in the State. The Tennessee court begins its analysis by plainly announcing

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[1] The court itself commented that it had reduced the facts "perhaps to the point of oversimplification . . . . " Opinion, Appendix to Petition for Certiorari [hereinafter "App."] at 3a.

its intent to "delineate that level of 'presence' in the State of Tennessee that will justify the imposition of the types of taxes that are subject of this appeal." Opinion, App. at 18a. The Tennessee court recognizes that both *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967), and *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992), "are clear in their holding that in the context of a use tax, physical presence is required in order to satisfy the substantial nexus requirement of *Complete Auto*." Opinion, App. at 19a. It then declares that "[t]he only real issue is whether there is any reason to distinguish the present case from *Bellas Hess* and *Quill*." Opinion, App. at 19a.

After recounting the Commissioner's argument that those cases are distinguishable because they involved use taxes instead of franchise and excise taxes, the Tennessee court then concludes: "We must reject the Commissioner's argument. While it is true that the *Bellas Hess* and *Quill* decisions focused on use taxes, we find no basis for concluding that the analysis should be different in the present case." Opinion, App. at 19a. The court went on to summarize that "we feel that the outcome of this case is governed by *Bellas Hess* and *Quill*, as those decisions interpret the first prong of the *Complete Auto* test." Opinion, App. at 20a. Having just characterized *Bellas Hess* and *Quill* as clear in holding that physical presence is required to satisfy substantial nexus, the Tennessee court explicitly applied that same standard to the franchise and excise taxes before it in this case. Thus while it may not have set out with the express "purpose of decid[ing] whether 'physical presence' is required under the Commerce Clause," Opinion, App. at 25a, the Tennessee

court's pronouncements throughout the opinion clearly did apply a physical presence test to the taxes addressed in this case.

Furthermore, JCPNB's own statements in its Brief in Opposition to the Petition conflict with its argument in this regard. JCPNB recognizes that the Tennessee court applied well-established Commerce Clause principles as most recently explained in *Quill*, which embodies the physical presence test. Respondent's Brief in Opposition at 1. Further, JCPNB expressly states,

> The question before the Tennessee Court of Appeals was whether the Commerce Clause permits Tennessee to impose its franchise and excise tax on an out-of-state financial institution that conducted business with Tennessee residents exclusively through the U.S. Mail and *that had established no direct or indirect physical presence in Tennessee.*

Id. at 6 (emphasis added). Having admitted this, JCPNB cannot now credibly contend that the Tennessee court did not apply the *Quill* physical presence requirement to this case. Nor can JCPNB pretend that the opinion below is factbound. The Court did not dwell on the ways in which JCPNB exploits the Tennessee marketplace. The only fact in which the Court was interested was that JCPNB had no physical presence in Tennessee. Opinion, App. at 25a.

II.

THE COMMISSIONER IS NOT ADVOCATING A DUE PROCESS "MINIMUM CONTACTS" STANDARD, BUT A TEST THAT APPROPRIATELY EMBODIES THE COMMERCE CLAUSE'S STRUCTURAL CONCERNS ABOUT THE EFFECTS OF STATE REGULATION ON THE NATIONAL ECONOMY.

Contrary to JCPNB's assertion, the Commissioner is not advancing a "minimum contacts" standard such as that applied under due process to determine *in personam* jurisdiction. *See Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985). The standard that the Commissioner advocates is consistent with the "jurisdiction to tax" requirement of earlier decisions that is embodied in the "substantial nexus" prong of *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). The earlier decisions recognized the States' ability to tax those who exercise "the substantial privilege of carrying on business within the State." *Wisconsin v. J.C.Penney Co.*, 311 U.S. 435 (1940).[2] *Quill* did not obliterate the principles and cases upon

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[2] In the *Wisconsin* case, 311 U.S. at 444-45, the Court observed,

> The simple but controlling question is whether the state has given anything for which it can ask return. The substantial privilege of carrying on business in Wisconsin, which has here been given, clearly supports the tax, and the state has not given the less merely because it has conditioned the demand of the exaction upon happenings outside its own borders. The fact that a tax is contingent upon events brought to pass without a state does not destroy the nexus between such a tax and transactions within a state for which the tax is an exaction.

which this Court relied in *Complete Auto*.[3] While *Quill* reaffirmed the *Bellas Hess* holding as a special rule for mail-order sellers subject to a use-tax-collection duty, it did not discard the longstanding and more fundamental principles of nexus.

While the Court's earlier jurisdiction-to-tax decisions contained a due process component, *Quill* has clarified the extent of that component consistent with modern "minimum contacts" doctrine. 504 U.S. at 306-08. Those decisions also embodied a Commerce Clause component. As Justice Black noted in *Central Railroad Co. v. Pennsylvania*, 370 U.S. 607, 619 (1962) (Black, J., concurring), the jurisdiction-to-tax doctrine predated the adoption of the fourteenth amendment and did not originate in the Due Process Clause.[4] The jurisdiction-to-tax analysis was

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[3] *See, e.g., General Motors Corp. v. Washington*, 377 U.S. 436 (1964); *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959); *Memphis Natural Gas Co. v. Stone*, 335 U.S. 80 (1948); *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940), as cited in *Complete Auto*, 430 U.S. at 279 n.8.

[4] In *McLeod v. Dilworth*, 322 U.S. 349 (1944), Justice Rutledge noted that " 'Due process' and 'commerce clause' conceptions are not always sharply separable in dealing with these problems." 322 U.S. at 353 (Rutledge, J., separate opinion). He further observed,

> The old notion that "mere solicitation" is not "doing business" when it is regular, continuous and persistent is fast losing its force. . . . [F]or *every relevant constitutional consideration affecting taxation* of transactions, regular, continuous, persistent solicitation has the same economic, and should have the same legal, consequences as does maintaining an office . . . or maintaining a place of business. . . .

carried forward by *Complete Auto* in its "substantial nexus" prong, and was not repudiated by *Quill*. Under *Complete Auto*, this Court looks to the "practical effect" of the tax to determine if there is "the necessary connection with the taxing state to give 'jurisdiction to tax'. . . . " 430 U.S. at 281. JCPNB argues that principles of State taxing nexus under *Complete Auto* have been reduced, through *Quill*, to a physical presence test for all purposes. This position is demonstrably wrong, however, as shown by this Court's very careful confinement of *Quill*'s physical presence test to sales and use taxes.

In the context of franchise and income-based taxes, the physical presence test does not embody the concerns which this Court in *Quill* characterized as inherent in the Commerce Clause – those "structural concerns about the effects of state regulation on the national economy." *Quill*, 504 U.S. at 312. A physical presence test can arguably be justified in the sales and use tax area because of the weight of settled expectations of mail-order sellers and the unusual burdens of complying with the requirements of 6,000 sales and use tax jurisdictions throughout the country. Neither of these concerns applies to franchise and excise taxes.

In the first place, contrary to JCPNB's repeated assertions, this Court has never imposed a physical presence test on state jurisdiction to tax outside the very limited realm of sales and use taxation. As already noted, the *Quill* opinion in at least five passages stresses the limitation of its physical presence test to sales and use taxes.

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322 U.S. at 354 (Rutledge, J., separate opinion) (emphasis added).

Quill, 504 U.S. at 301, 307, 311, 315. The courts in Tennessee and in other states[5] that have applied the physical presence test outside of its original context have departed from this Court's doctrine and have produced decisions that make little practical, economic, or constitutional sense. Thus the reliance interests that influenced the Court in *Quill*, 504 U.S. at 316-17, are not present here. Contrary to JCPNB's suggestion, the Tennessee court's decision cannot be viewed as a "routine application of this Court's precedents" (Respondent's Brief in Opposition at 6), since there are no precedents of this Court that suggest any such doctrine.

Secondly, JCPNB's attempt to characterize the burden on multistate businesses in complying with franchise and income-based taxes as remotely equivalent to the burden of complying with sales taxes in 6,000 jurisdictions is hollow. Even assuming that it is more difficult to complete a state corporate income tax return than a sales and use tax return, the burden that concerned this Court in *Quill* was that of complying and reporting in 6,000 jurisdictions, generally on a monthly basis. 504 U.S. at 316 n.6. The potential requirement that a business divide its total sales among 6,000 jurisdictions each month and file returns accordingly was pertinent to structural concerns about the national economy. In contrast, it is neither unreasonable nor burdensome for a national business to fill out 48 income tax returns once a year, even if each

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[5] Other state decisions that have improperly applied the physical presence test of *Bellas Hess* and *Quill* to taxes other than sales and use taxes include *Guardian Industries Corp. v. Department of Treasury*, 198 Mich.App. 363, 499 N.W.2d 349 (1993); and *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. App. 2000).

such return requires more skill than completing a single sales tax return. The burdens are not remotely comparable, as leading commentators have observed. *See* Petition for Certiorari at 15-16.

Imposing a physical presence test for state franchise and income-based taxes does not properly foster national economic activity. Instead, it unduly restricts the States from playing their proper role in government, and from securing the revenues necessary to perform their sovereign functions, which include maintaining the infrastructure that enables much national economic activity to occur. The main result of imposing a physical presence test is to make State taxing authority hopelessly antiquated and incapable of adapting to today's business environment, in which physical presence in a State is largely irrelevant to the nature and quantity of business conducted there. This Court has previously let stand a decision of the South Carolina Supreme Court that upheld the application of that State's income tax and business license fees to royalty income of a corporation having no physical presence in South Carolina. *Geoffrey, Inc. v. South Carolina Tax Commission*, 313 S.C. 15, 437 S.E.2d 13, *cert. denied*, 510 U.S. 992 (1993).[6] It is appropriate for this Court to grant plenary review of the decision of the Tennessee court below that is in direct conflict with *Geoffrey* and numerous other decisions in other states, as noted in the Petition for Certiorari and the *amicus curiae*

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[6] JCPNB's effort to recharacterize *Geoffrey* as recognizing an "intangible" physical presence rule is inconsistent with the whole thrust of the South Carolina court. That court did not try to "force-fit" the case into the *Quill* standard; rather it found *Bellas Hess* and *Quill* inapplicable because they are limited to sales and use taxes. 437 S.E.2d at 18 n.4 & accompanying text.

brief filed in this case by New Jersey on behalf of eighteen states. The specific standards for state taxing nexus obviously are not "well-settled," despite JCPNB's assertions to the contrary. Respondent's Brief in Opposition at 16. As the plethora of administrative and judicial proceedings around the country demonstrates, the area is not settled at all, and it will remain a quagmire of uncertainty and conflict until this Court addresses it authoritatively. This case offers an ideal vehicle for the Court to do so.

III.

THIS COURT OUGHT NOT LEAVE THIS TOPIC IN A QUAGMIRE IN ANTICIPATION OF UNCERTAIN ACTION BY CONGRESS.

In *Quill*, this Court indicated that the topic of that decision was an appropriate one for Congressional consideration. 504 U.S. at 318-19. This Court nevertheless granted Quill's application for certiorari and clarified the topic in the absence of action by Congress. The Court should take a similar approach in this case. In fact, action here is more urgent than it was in *Quill*, because this Court has pronounced no clear and specific Commerce Clause standard for State franchise and income-based taxes, while there was clear precedent for guidance in *Quill* as to sales and use taxes. In the absence of action by Congress, which is extremely uncertain, the courts must develop some principles to govern this topic. The various State courts are presently in great disarray, and the current disagreements in their pronouncements will continue until this Court speaks. That Congress might specify statutory criteria at some uncertain future date does not relieve this Court of the duty of establishing a rule of constitutional law to resolve the conflicts and confusion

on the topic, until Congress does act. In fact, Congress would no doubt be aided in its action by a clear pronouncement from this Court as to how its general Commerce Clause principles apply to State franchise and income-based taxes.

CONCLUSION

For these reasons, in addition to those stated in the Commissioner's original Petition and in the *amicus curiae* briefs filed in this case by New Jersey on behalf of eighteen states and by the Multistate Tax Commission, a Writ of Certiorari should issue to review the judgment of the Tennessee Court of Appeals.

Respectfully submitted,

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